1991


American Institute of Certified Public Accountants. Examinations Division

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Uniform CPA Examination
May 1987-May 1991
Selected Questions & Unofficial Answers
Indexed To Content Specification Outlines
Accounting Practice Accounting Theory Auditing Business Law
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American Institute of Certified Public Accountants
FOREWORD

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

This book contains selected questions and unofficial answers from the nine Uniform Certified Public Accountant Examinations from May 1991 back to May 1987. 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 (87 through 91); 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 1991 Uniform CPA Examination are included at the end of the book. Following the November 1991 exam’s questions and unofficial answers is an index of the exam’s questions that classifies them in accordance with each section’s Content Specification Outline.

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

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

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

January 1992
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MUL TIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

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

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

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

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

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

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

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

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

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

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

1M89

Items 2 through 4 are based on the following:

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

Shaw Corp.  
TRIAL BALANCE  
December 31, 1988

<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>2,695,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,185,000</td>
</tr>
<tr>
<td>Property, plant and equipment (net)</td>
<td>7,366,000</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>$ 1,801,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>654,000</td>
</tr>
<tr>
<td>Deferred income tax liability</td>
<td>85,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>2,300,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>3,680,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/88</td>
<td>3,350,000</td>
</tr>
<tr>
<td>Net sales and other revenues</td>
<td>13,360,000</td>
</tr>
<tr>
<td>Costs and expenses</td>
<td>11,180,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>1,129,000</td>
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<tr>
<td><strong>$25,230,000</strong></td>
<td><strong>$25,230,000</strong></td>
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Other financial data for the year ended December 31, 1988:

- Included in accounts receivable is $1,000,000 due from a customer and payable in quarterly installments of $125,000. The last payment is due December 30, 1990.
The balance in the deferred income tax liability account pertains to a temporary difference that arose in a prior year, of which $15,000 is expected to be paid in 1989. Shaw elected to apply the provisions of FASB Statement No. 96, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1988.

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

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

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

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

B. Income Statement

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

Net sales revenue $187,000
Results from discontinued operations:
   Loss from operations of segment (net of $1,200 tax effect) $(2,400)
   Gain on disposal of segment (net of $7,200 tax effect) 14,400

Interest revenue 10,200
Gain on sale of equipment 4,700
Cumulative change in 1988 and 1989 income due to change in depreciation method (net of $750 tax effect) 1,500
Total revenues $215,400

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

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

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

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
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<tbody>
<tr>
<td>Net sales</td>
<td>$1,600,000</td>
<td></td>
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<tr>
<td>Cost of goods sold</td>
<td>$960,000</td>
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<tr>
<td>Selling expenses</td>
<td>235,000</td>
<td></td>
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<tr>
<td>Administrative expenses</td>
<td>150,000</td>
<td></td>
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<tr>
<td>Interest expense</td>
<td>25,000</td>
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</tr>
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<td>Adjustment due to accounting change in depreciation method</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Gain on debt extinguishment</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$1,410,000</td>
<td>$1,610,000</td>
</tr>
</tbody>
</table>

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

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

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

1M98

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:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$150,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>Loss on sale of equipment</td>
<td>9,000</td>
</tr>
<tr>
<td>Commissions to salespersons</td>
<td>10,000</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>5,000</td>
</tr>
<tr>
<td>Freight out</td>
<td>3,000</td>
</tr>
<tr>
<td>Loss on early retirement of long-term debt</td>
<td>10,000</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>3,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

Other information

Finished goods inventory:
- January 1, 1987: $100,000
- December 31, 1987: $ 90,000

Karl's income tax rate is 30%.

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

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

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

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

C. Statement of Cash Flows

1M91#4. In 1990, a tornado completely destroyed a building belonging to Holland Corp. The building cost $100,000 and had accumulated depreciation of $48,000 at the time of the loss. Holland received a cash settlement from the insurance company and reported an extraordinary loss of $21,000. In Holland's 1990 cash flow statement, the net change reported in the cash flows from investing activities section should be a
   a. $10,000 increase.
   b. $21,000 decrease.
   c. $31,000 increase.
   d. $52,000 decrease.

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

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

In Metro's 1990 cash flow statement, the reported net cash provided by operating activities should be
   a. $150,400
   b. $148,300
   c. $144,900
   d. $142,800

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

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

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

If the direct method is used in the 1990 statement of cash flows, Planet should report cash collected from customers as
   a. $447,800
   b. $446,800
   c. $429,200
   d. $428,200

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

<table>
<thead>
<tr>
<th></th>
<th>January 1</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$11,500</td>
<td>$14,500</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>400</td>
<td>500</td>
</tr>
<tr>
<td>Prepaid rent expense</td>
<td>6,200</td>
<td>4,100</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>9,700</td>
<td>11,200</td>
</tr>
</tbody>
</table>

Kresley's 1990 net income is $75,000. Net cash provided by operating activities in the statement of cash flows should be
   a. $72,700
   b. $74,300
   c. $75,500
   d. $75,700

AP-3
1M91#10. During 1990, Teb, Inc. had the following activities related to its financial operations:

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

In Teb’s 1990 statement of cash flows, net cash used in financing activities should be
a. $717,000
b. $716,000
c. $597,000
d. $535,000

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

• Acquired 2,000 shares of stock in Maybel, Inc. for $26,000.

• Sold an investment in Rate Motors for $35,000 when the carrying value was $33,000.

• Acquired a $50,000, 4-year certificate of deposit from a bank. (During the year, interest of $3,750 was paid to Alp.)

• Collected dividends of $1,200 on stock investments.

In Alp’s 1990 statement of cash flows, net cash used in investing activities should be
a. $37,250
b. $38,050
c. $39,800
d. $41,000

1M89

Items 5 through 7 are based on the following:

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

<table>
<thead>
<tr>
<th>December 31,</th>
<th>1988</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$230,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>300,000</td>
<td>-</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>510,000</td>
<td>510,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>680,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Plant assets</td>
<td>1,700,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(450,000)</td>
<td>(450,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>90,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$3,260,000</td>
<td>$2,160,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued liabilities</td>
</tr>
<tr>
<td>Short-term debt</td>
</tr>
<tr>
<td>Common stock $10 par</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Total liabilities and stockholders’ equity</td>
</tr>
</tbody>
</table>

Information relating to 1988 activities

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

5. Net cash provided by Dice’s 1988 operating activities was
a. $690,000
b. $915,000
c. $940,000
d. $950,000

6. Net cash used in Dice’s 1988 investing activities was
a. $1,115,000
b. $895,000
c. $865,000
d. $815,000

7. Net cash provided by Dice’s 1988 financing activities was
a. $305,000
b. $440,000
c. $455,000
d. $545,000

1M89

Items 9 and 10 are based on the following:

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

• Acquired 50% of Hoag Corp.’s common stock for $225,000 cash which was borrowed from a bank.
• Issued 5,000 shares of its preferred stock for land having a fair value of $400,000.
• Issued 500 of its 11% debenture bonds, due 1996, for $490,000 cash.
• Purchased a patent for $275,000 cash.
• Paid $150,000 toward a bank loan.
• Sold investment securities for $995,000.
• Had a net increase in customer deposits of $110,000.
9. Brock’s net cash provided by investing activities for 1988 was
   a. $370,000
   b. $495,000
   c. $595,000
   d. $770,000

10. Brock’s net cash provided by financing activities for 1988 was
    a. $565,000
    b. $675,000
    c. $715,000
    d. $825,000

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

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

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

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

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

D. Statement of Owners’ Equity

1M91#12. Mag, Inc.’s December 31, 1990, unadjusted current assets and stockholders’ equity sections are as follows:

<table>
<thead>
<tr>
<th>Current Assets:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Investments in marketable equity securities (including $75,000 of Mag, Inc. common stock)</td>
</tr>
<tr>
<td>Trade accounts receivable</td>
</tr>
<tr>
<td>Inventories</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Stockholders’ Equity:

<table>
<thead>
<tr>
<th>Stockholders’ Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Retained earnings (deficit)</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

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

Mag’s stockholders’ equity at December 31, 1990, should be

a. $556,000
b. $500,000
c. $481,000
d. $425,000

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

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1989</td>
<td>$150,000</td>
<td>$130,000</td>
</tr>
<tr>
<td>December 31, 1990</td>
<td>150,000</td>
<td>160,000</td>
</tr>
</tbody>
</table>

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

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

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

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

| Common stock, $5 par value, authorized 200,000 shares, issued 100,000 shares | $500,000 |
| Additional paid-in capital            | 1,500,000 |
| Retained earnings                     | 516,000   |

Less treasury stock, at cost, 5,000 shares | 40,000
Total stockholders’ equity | $2,476,000

The following events occurred in 1990:

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

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

19. In Pugh's December 31, 1990, statement of stockholders' equity, the par value of the issued common stock should be
   a. $550,000
   b. $518,000
   c. $291,000
   d. $275,000

20. The number of outstanding common shares at December 31, 1990, should be
   a. 222,000
   b. 220,000
   c. 216,000
   d. 212,000

1M89#3. Jay Company acquired a wholly-owned foreign subsidiary on January 1, 1988. The stockholders' equity section of the December 31, 1988 consolidated balance sheet follows:

<table>
<thead>
<tr>
<th>Common stock</th>
<th>$ 500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional paid-in capital</td>
<td>200,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Less: Contra account</td>
<td>600,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

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

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

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

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

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Contra accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $ 900,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>b. $1,000,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>c. $1,100,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>d. $1,200,000</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Common stock, par value $20;</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000 shares authorized;</td>
</tr>
<tr>
<td>50,000 shares outstanding</td>
</tr>
</tbody>
</table>

Additional paid-in capital ($3 per share on issuance of common stock) 150,000
Retained earnings 1,350,000

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

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

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

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

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

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Preferred stock</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $150,000</td>
<td>$30,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>b. $150,000</td>
<td>$75,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $10,000</td>
<td>$75,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>d. $10,000</td>
<td>$30,000</td>
<td>$185,000</td>
</tr>
</tbody>
</table>

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

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

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

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Preferred stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 60,000</td>
<td>17,000</td>
</tr>
<tr>
<td>b. 60,000</td>
<td>18,000</td>
</tr>
<tr>
<td>c. 63,000</td>
<td>17,000</td>
</tr>
<tr>
<td>d. 63,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>
E. Consolidated Financial Statements or Worksheets

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

<table>
<thead>
<tr>
<th>Cost</th>
<th>Accumulated depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $1,100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>b. $1,100,000</td>
<td>$290,000</td>
</tr>
<tr>
<td>c. $900,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>d. $850,000</td>
<td>$42,500</td>
</tr>
</tbody>
</table>

1M91

Items 13 through 17 are based on the following:

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

**BALANCE SHEETS**

*December 31, 1990*

<table>
<thead>
<tr>
<th></th>
<th>Purl</th>
<th>Scott</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>$80,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>140,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>310,000</td>
<td>135,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>625,000</td>
<td>280,000</td>
</tr>
<tr>
<td>Investment in Scott (equity method)</td>
<td>390,000</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1,325,000</td>
<td>$415,000</td>
</tr>
</tbody>
</table>

**Liabilities and Stockholders’ Equity**

<table>
<thead>
<tr>
<th></th>
<th>Purl</th>
<th>Scott</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$160,000</td>
<td>$95,000</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>110,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>270,000</td>
<td>125,000</td>
</tr>
<tr>
<td><strong>Stockholders’ equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>300,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>—</td>
<td>10,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>755,000</td>
<td>230,000</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>1,055,000</td>
<td>290,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td>$1,325,000</td>
<td>$415,000</td>
</tr>
</tbody>
</table>

**INCOME STATEMENTS**

*For the Year Ended December 31, 1990*

<table>
<thead>
<tr>
<th></th>
<th>Purl</th>
<th>Scott</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,000,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>1,540,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>460,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>260,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Equity in earnings of Scott</td>
<td>60,000</td>
<td>—</td>
</tr>
<tr>
<td><strong>Income before income taxes</strong></td>
<td>260,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>60,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$200,000</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

**Additional Information:**

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $410,000 and $160,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990. Purl's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.

- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.

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

- Both Purl and Scott paid income taxes at the rate of 30%.

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

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

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

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

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

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

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

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

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

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

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

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

**BALANCE SHEETS**
**December 31, 1988**

<table>
<thead>
<tr>
<th></th>
<th>Dean</th>
<th>Kay</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>$430,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>360,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Investment in subsidiary (equity method)</td>
<td>650,000</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1,440,000</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dean</th>
<th>Kay</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities and Stockholders' Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>$130,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>320,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>370,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>620,000</td>
<td>280,000</td>
</tr>
<tr>
<td><strong>Total stockholders' equity</strong></td>
<td>1,310,000</td>
<td>560,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td>$1,440,000</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

**INCOME STATEMENTS**
**For the Year Ended December 31, 1988**

<table>
<thead>
<tr>
<th></th>
<th>Dean</th>
<th>Kay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,100,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>770,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>330,000</td>
<td>200,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Dean</th>
<th>Kay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other operating expenses</td>
<td>120,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>210,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Equity in earnings of Kay</td>
<td>60,000</td>
<td>—</td>
</tr>
<tr>
<td><strong>Income before federal income taxes</strong></td>
<td>270,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Provision for federal income taxes</td>
<td>70,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$200,000</td>
<td>$70,000</td>
</tr>
</tbody>
</table>
8. In Dean’s 1988 consolidated income statement, what amount should be reported for amortization of goodwill?
   a. $0
   b. $ 6,000
   c. $ 9,000
   d. $10,000

1N89

Items 10 and 11 are based on the following:

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

<table>
<thead>
<tr>
<th>Poe</th>
<th>Saxe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,300,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Total</td>
<td>$6,800,000</td>
</tr>
</tbody>
</table>

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

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

1M89

Items 55 and 56 are based on the following:

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

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

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

1M89

Items 57 and 58 are based on the following:

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

<table>
<thead>
<tr>
<th>Purl</th>
<th>Scott</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td></td>
</tr>
<tr>
<td>Six months ended 6/30/88</td>
<td>$750,000</td>
</tr>
<tr>
<td>Six months ended 12/31/88</td>
<td>825,000</td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
</tr>
<tr>
<td>March 25, 1988</td>
<td>950,000</td>
</tr>
<tr>
<td>November 15, 1988</td>
<td>—</td>
</tr>
</tbody>
</table>

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

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

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

1N88

Items 2 through 6 are based on the following:

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

<table>
<thead>
<tr>
<th>Polk</th>
<th>Strass</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td>90,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$160,000</td>
</tr>
</tbody>
</table>

AP-9
On January 2, 1988, Polk borrowed $60,000 and used the proceeds to purchase 90% of the outstanding common shares of Strass. This debt is payable in 10 equal annual principal payments, plus interest, beginning December 30, 1988. The excess cost of the investment over Strass' book value of acquired net assets should be allocated 60% to inventory and 40% to goodwill.

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

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

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

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

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

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

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

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

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

1M88
Items 13 through 17 are based on the following information:

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

<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><strong>Total</strong></td>
<td><strong>$17,000,000</strong></td>
<td><strong>$9,000,000</strong></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><strong>Net income</strong></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>
</tbody>
</table>

| **Dividends paid** |       |      |
| April 1, 1987 | 1,300,000 | — |
| October 1, 1987 | — | 350,000 |

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

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

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

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

A. Cash, Marketable Securities, and Investments

1N90#1. In preparing its August 31, 1990 bank reconciliation, Apex Corp. has available the following information:
   Balance per bank statement, 8/31/90 $18,050
   Deposit in transit, 8/31/90 3,250
   Return of customer’s check for insufficient funds, 8/31/90 600
   Outstanding checks, 8/31/90 2,750
   Bank service charges for August 100

At August 31, 1990, Apex’s correct cash balance is
   a. $18,550
   b. $17,950
   c. $17,850
   d. $17,750

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

<table>
<thead>
<tr>
<th></th>
<th>Current assets</th>
<th>Noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$45,000</td>
<td>$65,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>39,000</td>
<td>57,000</td>
</tr>
<tr>
<td>Aggregate lower of cost or market value applied to each security in the portfolio</td>
<td>38,000</td>
<td>56,000</td>
</tr>
</tbody>
</table>

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

1N90#3. On January 2, 1986, Beal, Inc. acquired a $70,000 whole-life insurance policy on its president.

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

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

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per bank statement, 3/31/90</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, 3/31/90</td>
<td>$44,200</td>
</tr>
</tbody>
</table>

The annual premium is $2,000. The company is the owner and beneficiary. Beal charged officer’s life insurance expense as follows:
   1986 $2,000
   1987 1,800
   1988 1,500
   1989 1,100

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

Data per bank for the month of April 1990 follow:

Deposits $58,400
Disbursements 49,700

All reconciling items at March 31, 1990 cleared the bank in April. Outstanding checks at April 30, 1990 totaled $7,000. There were no deposits in transit at April 30, 1990. What is the cash balance per books at April 30, 1990?

a. $48,200  
b. $52,900  
c. $55,200  
d. $58,500

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

<table>
<thead>
<tr>
<th>Security</th>
<th>Cost</th>
<th>Market value at 12/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>$36,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>E</td>
<td>80,000</td>
<td>60,000</td>
</tr>
<tr>
<td>F</td>
<td>180,000</td>
<td>186,000</td>
</tr>
<tr>
<td></td>
<td><strong>$296,000</strong></td>
<td><strong>$286,000</strong></td>
</tr>
</tbody>
</table>

Scott appropriately carries these securities at the lower of aggregate cost or market value. The amount of unrealized loss on these securities in Scott’s 1989 income statement should be

a. $20,000  
b. $14,000  
c. $10,000  
d. $0

1M90#3. On April 1, 1989, Saxe, Inc. purchased $200,000 face value, 9% U. S. Treasury Notes for $198,500, including accrued interest of $4,500. The notes mature July 1, 1990, and pay interest semi-annually on January 1 and July 1. Saxe uses the straight-line method of amortization. The notes were sold on December 1, 1989 for $206,500, including accrued interest of $7,500. In its October 31, 1989 balance sheet, the carrying amount of this investment should be

a. $194,000  
b. $196,800  
c. $197,200  
d. $199,000

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

a. $468,000  
b. $466,200  
c. $461,800  
d. $456,200

1M90#7 is based on the following:

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

7. The carrying amount of this investment in Lee’s December 31, 1988 balance sheet should be

a. $100,000  
b. $104,500  
c. $112,000  
d. $115,000

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

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

The proper amount to be shown as Cash on Ral’s balance sheet at December 31, 1988 is

a. $4,800  
b. $5,300  
c. $6,500  
d. $6,800

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

<table>
<thead>
<tr>
<th>In current assets</th>
<th>In noncurrent assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate cost</td>
<td>$300,000</td>
</tr>
<tr>
<td>Aggregate market value</td>
<td>240,000</td>
</tr>
<tr>
<td>Net unrealized loss</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

370,000

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Selected Questions

All of the declines are judged to be temporary. Valuation allowances at December 31, 1988 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>$140,000</td>
</tr>
<tr>
<td>b. $60,000</td>
<td>$ 80,000</td>
</tr>
<tr>
<td>c. $80,000</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>d. $140,000</td>
<td>$     0</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

Cash in banks includes $600,000 of compensating balances against short-term borrowing arrangements. The compensating balances are not legally restricted as to withdrawal by Burr. In the current assets section of Burr's December 31, 1987 balance sheet, total cash should be reported at
a. $1,775,000
b. $2,250,000
c. $2,375,000
d. $3,975,000

1N88#15. On January 1, 1987, Grey Company purchased as a long-term investment 400 of the $1,000 face amount, 8% bonds of Winn Corp. for $369,000 to yield 10% annually. The bonds pay interest semiannually on July 1 and January 1, and mature on January 1, 1992. Grey uses the interest method of amortization. The bonds should be reported (rounded) on Grey's December 31, 1987 balance sheet at
a. $363,980
b. $364,100
c. $373,900
d. $374,020

1N88#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>In current</th>
<th>In noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>assets</td>
<td>assets</td>
</tr>
</tbody>
</table>

- Aggregate cost $185,000
- Aggregate market value 150,000
- Net unrealized loss $ 35,000

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>

1N88#12. In preparing its bank reconciliation at December 31, 1987, Case Company has available the following data:

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

Case's adjusted cash in bank balance at December 31, 1987 is
a. $36,525
b. $36,450
c. $36,125
d. $36,050

1N88#18. On December 31, 1986, Wall 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 12/31/87</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$39,000</td>
<td>$36,000</td>
</tr>
<tr>
<td>B</td>
<td>50,000</td>
<td>$55,000</td>
</tr>
<tr>
<td>C</td>
<td>96,000</td>
<td>$85,000</td>
</tr>
</tbody>
</table>
**Accounting Practice**

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

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

**1N87#1.** Apex Corporation's checkbook balance on December 31, 1986, was $160,000. The same date Apex held the following items in its safe:

- A $5,000 check payable to Apex, dated January 2, 1987, that was not included in the December 31 checkbook balance.
- A $3,500 check payable to Apex, deposited December 22 and included in the December 31 checkbook balance, that was returned by the bank on December 30 marked NSF. The check was redeposited January 2, 1987, and cleared January 7.
- A $25,000 check, payable to a supplier and drawn on Apex's account, that was dated and recorded December 31, but was not mailed until January 15, 1987.

In its December 31, 1986 balance sheet, Apex should report cash at

a. $156,500  
b. $161,500  
c. $181,500  
d. $185,000

**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><strong>$425,000</strong></td>
<td><strong>$412,000</strong></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 semi-annually 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  
Future amount of ordinary annuity of 1 at 8% for 5 periods = 5.87  
Present value of 1 at 8% for 6 periods = 0.63  
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>160,000</td>
</tr>
<tr>
<td>Aggregate lower of cost or market value applied to each security in the portfolio</td>
<td>152,000</td>
</tr>
</tbody>
</table>

AP-14
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 non-current marketable equity securities respectively at
   a. $20,000 and $50,000.
   b. $20,000 and $0.
   c. $28,000 and $65,000.
   d. $28,000 and $50,000.

1N90#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

B. Receivables and Accruals

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

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

At December 31, 1989, the correct total of Mann's current net receivables was
   a. $94,000
   b. $120,000
   c. $124,000
   d. $150,000

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Installment sales</th>
<th>Cost of installment sales</th>
<th>Gross profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$300,000</td>
<td>$225,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>1988</td>
<td>$375,000</td>
<td>$285,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>1989</td>
<td>$360,000</td>
<td>$252,000</td>
<td>$108,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate of gross profit on installment sales</th>
<th>Balance of deferred gross profit at year end</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>25%</td>
<td>$52,500</td>
</tr>
<tr>
<td>1988</td>
<td>24%</td>
<td>$54,000</td>
</tr>
<tr>
<td>1989</td>
<td>30%</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

What amount of installment accounts receivable should be presented in Kemp's December 31, 1989 balance sheet?
   a. $270,000
   b. $277,500
   c. $279,000
   d. $300,000

2N90#1. On July 1, 1989, Kay Corp. sold equipment to Mando Co. for $100,000. Kay accepted a 10% note receivable for the entire sales price. This note is payable in two equal installments of $50,000 plus accrued interest on December 31, 1989 and December 31, 1990. On July 1, 1990, Kay discounted the note at a bank at an interest rate of 12%. Kay's proceeds from the discounted note were
   a. $48,400
   b. $49,350
   c. $50,350
   d. $51,700

2N90#3. On June 1, 1989, Yola Corp. loaned Dale $500,000 on a 12% note, payable in five annual installments of $100,000 beginning January 2, 1990. In connection with this loan, Dale was required to deposit $5,000 in a noninterest-bearing escrow account. The amount held in escrow is to be returned to Dale after all principal and interest payments have been made. Interest on the note is payable on the first day of each month beginning July 1, 1989. Dale made timely payments through November 1, 1989. On January 2, 1990, Yola received payment of the first principal installment plus all interest due. At December 31, 1989, Yola's interest receivable on the loan to Dale should be
   a. $0
   b. $5,000
   c. $10,000
   d. $15,000

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

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

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

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

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

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>8,000</td>
</tr>
<tr>
<td>Net credit sales</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

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

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

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

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$35,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

2N88#7. The following information pertains to Oro Corp.:

Credit sales for the year ended
December 31, 1988 $450,000
Credit balance in allowance for
uncollectible accounts at January 1, 1988 10,800
Bad debts written off during 1988 18,000
According to past experience, 3% of Oro's credit sales have been uncollectible. After provision is made for bad debt expense for the year ended December 31, 1988, the allowance for uncollectible accounts balance would be

- $6,300
- $13,500
- $24,300
- $31,500

2N88#8. Kul Co., which began operations on January 1, 1988, appropriately uses the installment sales method of accounting. The following information is available for 1988:

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

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

<table>
<thead>
<tr>
<th>Cash collections</th>
<th>Realized gross profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $300,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>b. $300,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>c. $200,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>d. $200,000</td>
<td>$160,000</td>
</tr>
</tbody>
</table>

2N88#15. Fay, Inc., received a $30,000, six-month, 12% interest-bearing note from a customer. The note was discounted the same day by Carr National Bank at 15%. The amount of cash received by Fay from the bank was

- $30,000
- $29,550
- $29,415
- $27,750

2N88#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

- $1,182,500
- $1,850,000
- $1,950,000
- $1,990,000

2N88#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?

- $104,000
- $99,000
- $98,800
- $97,200

2N88#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

- $18,460
- $20,000
- $23,075
- $25,000

2N88#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?

- $0
- $80,000
- $120,000
- $200,000
Accounting Practice

1M86#20. The following accounts were abstracted from Mann Company's unadjusted trial balance at December 31, 1987:

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

- a. $22,000
- b. $30,000
- c. $38,000
- d. $120,000

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

- a. $48,000
- b. $60,000
- c. $64,000
- d. $94,000

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:

- Present value of 1 at 12% for 10 periods: 0.322
- Present value of ordinary annuity of 1 at 12% for 10 periods: 5.650

In its December 31, 1986 balance sheet, Park should report the carrying amount of the note at

- a. $16,100
- b. $21,750
- c. $28,250
- d. $30,000

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

- a. $0
- b. $35,000
- c. $175,000
- d. $235,000

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First month's rent</td>
<td>$15,000</td>
</tr>
<tr>
<td>Security deposit</td>
<td>25,000</td>
</tr>
</tbody>
</table>

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.
- Forgave the $64,000 accrued interest.
- Extended the maturity date to December 31, 1988.
- Annual interest of $60,000 is to be paid to Grey on December 31, 1987 and 1988.

On December 31, 1986, Grey must recognize a loss from restructuring of

- a. $144,000
- b. $200,000
- c. $204,000
- d. $264,000

C. Inventories

1M91

Item 21 is based on the following:

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completion of detail program design</td>
<td>$13,000</td>
</tr>
<tr>
<td>Costs incurred for coding and testing to</td>
<td></td>
</tr>
<tr>
<td>establish technological feasibility</td>
<td>10,000</td>
</tr>
<tr>
<td>Other coding costs after establishment of technological feasibility</td>
<td>24,000</td>
</tr>
<tr>
<td>Other testing costs after establishment of technological feasibility</td>
<td>20,000</td>
</tr>
<tr>
<td>Costs of producing product masters for training materials</td>
<td>15,000</td>
</tr>
<tr>
<td>Duplication of computer software and training materials from product masters (1,000 units)</td>
<td>25,000</td>
</tr>
<tr>
<td>Packaging product (500 units)</td>
<td>9,000</td>
</tr>
</tbody>
</table>
21. In Pitt's December 31, 1990, balance sheet, what amount should be reported in inventory?
   a. $25,000  
   b. $34,000  
   c. $40,000  
   d. $49,000

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

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

Fenn's 1989 inventoriable cost was:
   a. $400,000
   b. $403,000
   c. $408,000
   d. $413,000

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Received</th>
<th>Cost</th>
<th>Issued</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>$8.00</td>
<td>3,200</td>
<td></td>
</tr>
<tr>
<td>1/11/90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue</td>
<td></td>
<td>1,600</td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td>1/22/90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase</td>
<td>4,800</td>
<td>$9.60</td>
<td></td>
<td>6,400</td>
</tr>
</tbody>
</table>

The moving-average unit cost of X inventory at January 31, 1990 is:
   a. $8.80
   b. $9.96
   c. $9.20
   d. $9.60

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

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>$12,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>60,000</td>
</tr>
<tr>
<td>Net additional markups</td>
<td></td>
</tr>
<tr>
<td>Net markdowns</td>
<td>20,000</td>
</tr>
<tr>
<td>Sales revenue</td>
<td></td>
</tr>
</tbody>
</table>

If the lower of cost or market rule is disregarded, what would be the estimated cost of the ending inventory?
   a. $24,000
   b. $20,800
   c. $20,000
   d. $19,200

**1M90#14.** West Retailers purchased merchandise with a list price of $20,000, subject to trade discounts of 20% and 10%, with no cash discounts allowable. West should record the cost of this merchandise as:
   a. $14,000
   b. $14,400
   c. $15,600
   d. $20,000

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

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

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

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

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

<table>
<thead>
<tr>
<th>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/88</td>
<td>$147,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>833,000</td>
</tr>
<tr>
<td>Additional markups</td>
<td></td>
</tr>
<tr>
<td>Available for sale</td>
<td>$980,000</td>
</tr>
</tbody>
</table>

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

**1N88#17.** Dell Company's inventory at December 31, 1987 was $1,200,000 based on a physical count of goods priced at cost, and before any necessary year-end adjustments relating to the following:
- Included in the physical count were goods billed to a customer F.O.B. shipping point on December 30, 1987. These goods had a cost of $25,000 and were picked up by the carrier on January 7, 1988.
- Goods shipped F.O.B. shipping point on December 28, 1987, from a vendor to Dell were received on January 4, 1988. The invoice cost was $60,000.

What amount should Dell report as inventory in its December 31, 1987 balance sheet?

a. $1,175,000
b. $1,200,000
c. $1,235,000
d. $1,260,000

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

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

Ward records losses that result from applying the lower of cost or market rule. At December 31, 1987, the loss that Ward should recognize is

a. $0
b. $6,000
c. $14,000
d. $20,000

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Inventory at current year cost</th>
<th>Inventory at base year 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

1M87#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

1M87#9. Dart Company’s accounting records indicated the following information:

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

a. $25,000
b. $100,000
c. $175,000
d. $225,000

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.

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

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

a. $2,625
b. $2,940
c. $3,600
d. $4,200
D. Property, Plant, and Equipment Owned or Leased

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipping</td>
<td>$3,000</td>
</tr>
<tr>
<td>Installation</td>
<td>4,000</td>
</tr>
<tr>
<td>Testing</td>
<td>5,000</td>
</tr>
</tbody>
</table>

In Shaw's December 31, 1990, balance sheet, the machine's cost should be reported as

a. $126,000
b. $129,000
c. $133,000
d. $138,000

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Building</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$60,000</td>
<td>$360,000</td>
</tr>
<tr>
<td>b.</td>
<td>$62,000</td>
<td>$360,000</td>
</tr>
<tr>
<td>c.</td>
<td>$64,000</td>
<td>$358,000</td>
</tr>
<tr>
<td>d.</td>
<td>$65,000</td>
<td>$362,000</td>
</tr>
</tbody>
</table>

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

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

1M91#26. In January 1988, Winn Corp. purchased equipment at a cost of $500,000. The equipment had an estimated salvage value of $100,000, an estimated 8-year useful life, and was being depreciated by the straight-line method. Two years later, it became apparent to Winn that this equipment suffered a permanent impairment of value. In January 1990, management determined the carrying amount should be only $125,000, with a 2-year remaining useful life, and the salvage value should be reduced to $25,000. In Winn's December 31, 1990, balance sheet, the equipment should be reported at a carrying amount of

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

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

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Estimated life</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales office</td>
<td>10 years</td>
<td>$47,000</td>
</tr>
<tr>
<td>Warehouse</td>
<td>25 years</td>
<td>75,000</td>
</tr>
<tr>
<td>Parking lot</td>
<td>15 years</td>
<td>18,000</td>
</tr>
</tbody>
</table>

Amortization of leasehold improvements for 1989 should be

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine</td>
<td>$75,000</td>
</tr>
<tr>
<td>Labor to install machine</td>
<td>14,000</td>
</tr>
<tr>
<td>Parts added in rearranging the assembly line to provide future benefits</td>
<td>40,000</td>
</tr>
<tr>
<td>Labor and overhead to rearrange the assembly line</td>
<td>18,000</td>
</tr>
</tbody>
</table>

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

a. $147,000
b. $107,000
c. $ 89,000
d. $ 75,000
2N90#5. On July 1, 1986, Rey Corp. purchased computer equipment at a cost of $360,000. This equipment was estimated to have a six-year life with no residual value and was depreciated by the straight-line method. On January 3, 1989, Rey determined that this equipment could no longer process data efficiently, that its value had been permanently impaired, and that $70,000 could be recovered over the remaining useful life of the equipment. What carrying amount should Rey report on its December 31, 1989 balance sheet for this equipment?
   a. $0
   b. $ 50,000
   c. $ 70,000
   d. $150,000

2N90#13. Vore Corp. bought equipment on January 2, 1988 for $200,000. This equipment had an estimated useful life of five years and a salvage value of $20,000. Depreciation was computed by the 150% declining balance method. The accumulated depreciation balance at December 31, 1989 should be
   a. $102,000
   b. $ 98,000
   c. $ 91,800
   d. $ 72,000

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

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

In East's December 31, 1989 balance sheet, what amount should be reported as land?
   a. $311,000
   b. $321,000
   c. $332,000
   d. $336,000

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

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

The overhaul resulted in a significant increase in production. Neither the attachment nor the overhaul increased the estimated useful life of the press. What amount of the above costs should be capitalized?
   a. $0
   b. $ 84,000
   c. $120,000
   d. $160,000

1M90#18. On January 2, 1989, Ames Corp. signed an eight-year lease for office space. Ames has the option to renew the lease for an additional four-year period on or before January 2, 1996. During January 1989, Ames incurred the following costs:
   a. $120,000 for general improvements to the leased premises with an estimated useful life of ten years.
   b. $50,000 for office furniture and equipment with an estimated useful life of ten years.

At December 31, 1989, Ames' intentions as to exercise of the renewal option are uncertain. A full year's amortization of leasehold improvements is taken for calendar year 1989. In Ames' December 31, 1989 balance sheet, accumulated amortization should be
   a. $10,000
   b. $15,000
   c. $17,000
   d. $21,250

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

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

During January 1990, before the 1989 financial statements were issued, Pine received insurance proceeds of $500,000. On what amount should Pine base the determination of its loss on involuntary conversion?
   a. $520,000
   b. $530,000
   c. $550,000
   d. $560,000

1M90#23. On January 2, 1989, Ashe Company entered into a ten-year noncancellable lease requiring year-end payments of $100,000. Ashe's incremental borrowing rate is 12%, while the lessor's implicit interest rate, known to Ashe, is 10%. Present value factors for an ordinary annuity for ten periods are 6.145 at 10%, and 5.650 at 12%. Ownership of the property remains with the lessor at expiration of the lease. There is no bargain purchase option. The leased property has an estimated economic life of 12 years. What amount should Ashe capitalize for this leased property on January 2, 1989?
   a. $1,000,000
   b. $ 614,500
   c. $ 565,000
   d. $0
Selected Questions

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of new boiler</td>
<td>$60,000</td>
</tr>
<tr>
<td>Carrying amount of old boiler</td>
<td>5,000</td>
</tr>
<tr>
<td>Fair value of old boiler</td>
<td>2,000</td>
</tr>
<tr>
<td>Installation cost of new boiler</td>
<td>8,000</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

1M88#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. $200,000  
d. $360,000

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of razing old building</td>
<td>$60,000</td>
</tr>
<tr>
<td>Title insurance and legal fees</td>
<td></td>
</tr>
<tr>
<td>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.

E. Intangibles and Other Assets

1M91

Item 22 is based on the following:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

On April 1, 1990, Wall’s inventory had a fair value of $150,000, and the property and equipment (net) had a fair value of $360,000. What is the amount of goodwill resulting from the business combination?

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

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

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

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

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

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

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

1N90#20. On January 1, 1986, Taft Co. purchased a patent for $714,000. The patent is being amortized over its remaining legal life of 15 years expiring on January 1, 2001. During 1989, Taft determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be reported in the balance sheet for the patent, net of accumulated amortization, at December 31, 1989?

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

1N90#21. Black Co., organized on January 2, 1989, had pretax accounting income of $500,000 and taxable income of $800,000 for the year ended December 31, 1989. The only temporary difference is accrued product warranty costs which are expected to be paid as follows:

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

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

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

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

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

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

a. $5,100
b. $4,080
c. $4,000
d. $1,700
Pine Football Company had a player contract with Duff that is recorded in its books at $500,000 on July 1, 1988. Ace Football Company had a player contract with Terry that is recorded in its books at $600,000 on July 1, 1988. On this date, Pine traded Duff to Ace for Terry and paid a cash difference of $50,000. The fair value of the Terry contract was $700,000 on the exchange date. After the exchange, the Terry contract should be recorded in Pine's books at
a. $550,000
b. $600,000
c. $650,000
d. $700,000

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

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$160,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>480,000</td>
<td>460,000</td>
</tr>
<tr>
<td>Property, plant and equipment (net)</td>
<td>980,000</td>
<td>1,040,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(360,000)</td>
<td>(360,000)</td>
</tr>
<tr>
<td>Net assets</td>
<td>$1,260,000</td>
<td>$1,300,000</td>
</tr>
</tbody>
</table>

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

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

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></th>
<th>Carrying amount</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$320,000</td>
<td>$320,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>360,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>580,000</td>
<td>540,000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,740,000</td>
<td>1,920,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(700,000)</td>
<td>(700,000)</td>
</tr>
<tr>
<td>Stockholders' equity</td>
<td>$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

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

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

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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></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>
</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

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

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

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

Hart should record the acquisition cost of the franchise on July 1, 1986, at

a. $135,200  
b. $120,000  
c. $98,200  
d. $87,200

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

A. Payables and Accruals

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

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

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

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

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

- Goods shipped to Kew F.O.B. destination on December 20, 1990, were received on January 6, 1991. The invoice cost was $50,000.
**1M91#37.** Kemp Co. must determine the December 31, 1990, year-end accruals for advertising and rent expenses. A $500 advertising bill was received January 7, 1991, comprising costs of $375 for advertisements in December 1990 issues, and $125 for advertisements in January 1991 issues of the newspaper.

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

In its December 31, 1990, balance sheet, Kemp should report accrued liabilities of

a. $12,875
b. $13,000
c. $13,100
d. $13,475

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

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

In Bart's December 31, 1990, balance sheet, what amount should be reported as a current liability for customer deposits?

a. $740,000
b. $690,000
c. $440,000
d. $0

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

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

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

<table>
<thead>
<tr>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $125,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $100,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>c. $100,000</td>
<td>$0</td>
</tr>
<tr>
<td>d. $25,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

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

- On December 27, 1989, Black wrote and recorded checks to creditors totaling $400,000 causing an overdraft of $100,000 in Black's bank account at December 31, 1989. The checks were mailed out on January 10, 1990.
- On December 28, 1989, Black purchased and received goods for $153,061, terms 2/10, n/30. Black records purchases and accounts payable at net amounts. The invoice was recorded and paid January 3, 1990.
- Goods shipped F.O.B. destination on December 20, 1989 from a vendor to Black were received January 2, 1990. The invoice cost was $65,000.

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

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

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

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

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

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

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

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Selected Questions

<table>
<thead>
<tr>
<th>Department payroll</th>
<th>Total wages</th>
<th>Federal income tax withheld</th>
<th>F.I.C.A.</th>
<th>Unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory</td>
<td>$ 60,000</td>
<td>$ 7,000</td>
<td>$56,000</td>
<td>$18,000</td>
</tr>
<tr>
<td>Sales</td>
<td>22,000</td>
<td>3,000</td>
<td>16,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Office</td>
<td>18,000</td>
<td>2,000</td>
<td>8,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
<td>$12,000</td>
<td>$80,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Assume the following payroll tax rates:

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

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

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

1990#13. On September 1, 1988, Cobb Co. issued a note payable to National Bank in the amount of $900,000, bearing interest at 12%, and payable in three equal annual principal payments of $300,000. On this date, the bank’s prime rate was 11%. The first payment for interest and principal was made on September 1, 1989. At December 31, 1989, Cobb should record accrued interest payable of:

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

1990#14. On January 1, 1989, Glen Co. leased a building to Dix Corp. for a ten-year term at an annual rental of $50,000. At inception of the lease, Glen received $200,000 covering the first two years’ rent of $100,000 and a security deposit of $100,000. This deposit will not be returned to Dix upon expiration of the lease but will be applied to payment of rent for the last two years of the lease. What portion of the $200,000 should be shown as a current and long-term liability, respectively, in Glen’s December 31, 1989 balance sheet?

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

1990#15. At December 31, 1989, the following information was provided by the Kerr Corp. pension plan administrator:

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

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

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

1990#16. Pine Corp.’s books showed pretax income of $800,000 for the year ended December 31, 1989. In the computation of federal income taxes, the following data were considered:

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

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

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

1990#22. Rice Co. salaried employees are paid bi-weekly. Advances made to employees are paid back by payroll deductions. Information relating to salaries follows:

<table>
<thead>
<tr>
<th>12/31/88</th>
<th>12/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee advances</td>
<td>$24,000</td>
</tr>
<tr>
<td>Accrued salaries payable</td>
<td>40,000</td>
</tr>
<tr>
<td>Salaries expense during the year</td>
<td>420,000</td>
</tr>
<tr>
<td>Salaries paid during the year (gross)</td>
<td>390,000</td>
</tr>
</tbody>
</table>

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

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

1990#23. At December 31, 1988, a $1,200,000 note payable was included in Cobb Corp.’s liability account balances. The note is dated October 1, 1988, bears interest at 15%, and is payable in three equal annual payments of $400,000. The first interest and principal...
Accounting Practice

payment was made on October 1, 1989. In its December 31, 1989 balance sheet, what amount should Cobb report as accrued interest payable for this note?

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from exempt municipal bonds</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation deducted for tax purposes in excess of depreciation deducted for financial statement purposes</td>
<td>$20,000</td>
</tr>
<tr>
<td>Estimated federal income tax payments made</td>
<td>$40,000</td>
</tr>
<tr>
<td>Enacted corporate income tax rate</td>
<td>30%</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

1M90#29. On December 30, 1989, Bart, Inc. purchased a machine from Fell Corp. in exchange for a noninterest bearing note requiring eight payments of $20,000. The first payment was made on December 30, 1989, and the others are due annually on December 30.

At date of issuance, the prevailing rate of interest for this type of note was 11%. Present value factors are as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Present value of ordinary annuity of 1 at 11%</th>
<th>Present value of annuity in advance of 1 at 11%</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>4.712</td>
<td>5.231</td>
</tr>
<tr>
<td>8</td>
<td>5.146</td>
<td>5.712</td>
</tr>
</tbody>
</table>

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

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

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

Container deposits at December 31, 1988 from deliveries in:

- 1987 | $150,000
- 1988 | 430,000

Deposits for containers delivered in 1989 | 780,000

Deposits for containers returned in 1989 from deliveries in:

- 1987 | $ 90,000
- 1988 | 250,000
- 1989 | 286,000

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

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
</table>
| Vacation pay | $90,000
| Sick pay | 60,000

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Selected Questions

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

- $0
- $60,000
- $90,000
- $150,000

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

<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>$10,000</td>
<td>$200,000</td>
<td>4%</td>
</tr>
<tr>
<td>B</td>
<td>14,000</td>
<td>400,000</td>
<td>6%</td>
</tr>
<tr>
<td>C</td>
<td>18,000</td>
<td>600,000</td>
<td>6%</td>
</tr>
<tr>
<td>Totals</td>
<td>$42,000</td>
<td>$1,200,000</td>
<td></td>
</tr>
</tbody>
</table>

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

- $70,000
- $68,000
- $28,000
- $26,000

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

- $2,500
- $5,000
- $7,500
- $10,000

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

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

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

- $203,000
- $162,000
- $121,000
- $109,000

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>$-</td>
<td>$10,600</td>
</tr>
<tr>
<td>February</td>
<td>600</td>
<td>7,420</td>
</tr>
<tr>
<td>March</td>
<td>$600</td>
<td>$27,560</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Sales revenue</th>
<th>Sales taxes payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $27,560</td>
<td>$1,560</td>
</tr>
<tr>
<td>b. $26,960</td>
<td>$600</td>
</tr>
<tr>
<td>c. $26,000</td>
<td>$1,560</td>
</tr>
<tr>
<td>d. $26,000</td>
<td>$960</td>
</tr>
</tbody>
</table>

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

- a. $50,000
- b. $40,000
- c. $35,000
- d. $28,000
1M89#21. Grey operates as a retail furrier. Some customers pick out furs and place deposits with Grey to set the furs aside for future delivery. Grey records the cash receipts on these transactions as lay-away plan sales. However, title to the fur passes to the customer only when the full sales price is received by Grey. The average gross margin on the furs is 75% of sales. The following pertinent data were taken from Grey's December 31, 1988 unadjusted trial balance:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular sales</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Lay-away plan sales</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Deposits from customers</td>
<td>$0</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Invoice date</th>
<th>Amount</th>
<th>Date shipped</th>
<th>Date received</th>
<th>FOB terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-3-89</td>
<td>8,000</td>
<td>12-22-88</td>
<td>12-24-88</td>
<td>Destination</td>
</tr>
<tr>
<td>1-2-89</td>
<td>15,000</td>
<td>12-28-88</td>
<td>1-2-89</td>
<td>Shipping point</td>
</tr>
<tr>
<td>12-26-88</td>
<td>12,000</td>
<td>1-2-89</td>
<td>1-3-89</td>
<td>Shipping point</td>
</tr>
<tr>
<td>1-10-89</td>
<td>9,000</td>
<td>12-31-88</td>
<td>1-5-89</td>
<td>Destination</td>
</tr>
<tr>
<td></td>
<td>$42,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1M88#38. The Ward Corp.'s books showed income of $300,000 before provision for income tax for the year ended December 31, 1988. In the computation of taxable income for federal income tax purposes, the following items should be noted:

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

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

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

1M88#13. Dean Company's accounts payable balance at December 31, 1987 was $1,800,000 before considering the following transactions:

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

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

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

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

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

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

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

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

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

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

- a. $475,000
- b. $585,000
- c. $630,000
- d. $655,000
5. Glen Corp. had the following data relating to its defined benefit pension plan at December 31, 1987:

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected benefit obligation</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Accumulated benefit obligation</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Total fair value of plan assets</td>
<td>2,500,000</td>
</tr>
</tbody>
</table>

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

6. 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

11. 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

17. Dix, Inc., a calendar-year corporation, reported the following operating income (loss) before income tax for its first three years of operations:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$100,000</td>
</tr>
<tr>
<td>1985</td>
<td>(200,000)</td>
</tr>
<tr>
<td>1986</td>
<td>400,000</td>
</tr>
</tbody>
</table>

There are no permanent or timing differences between operating income (loss) for financial and income tax reporting purposes. When filing its 1985 tax return, Dix did not elect to forgo the carryback of its loss for 1985. Assume a 40% tax rate for all years. What amount should Dix report as its income tax liability at December 31, 1986?

- a. $160,000
- b. $120,000
- c. $80,000
- d. $60,000

5. On December 30, 1986, Case Company purchased a machine from Pitt in exchange for a noninterest 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

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

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

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

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:

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Noncurrent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net pension cost for 1986</td>
<td>$190,000</td>
<td></td>
</tr>
<tr>
<td>Unrecognized prior service</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>cost, 12/31/86</td>
<td>$480,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated benefit</td>
<td>$480,000</td>
<td></td>
</tr>
<tr>
<td>obligation, 12/31/86</td>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Fair value of plan assets,</td>
<td>$500,000</td>
<td></td>
</tr>
<tr>
<td>12/31/86</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>

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

B. Deferred Revenues

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

a. $132,000
b. $100,000
c. $90,000
d. $72,000

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

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$420,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less cancellations</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Net sales</td>
<td>$400,000</td>
<td>$470,000</td>
</tr>
</tbody>
</table>

Subscriptions expirations:

<table>
<thead>
<tr>
<th>Year</th>
<th>Subscriptions</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>$120,000</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>$155,000</td>
<td>$130,000</td>
</tr>
<tr>
<td>1991</td>
<td>$125,000</td>
<td>200,000</td>
</tr>
<tr>
<td>1992</td>
<td>$140,000</td>
<td></td>
</tr>
</tbody>
</table>

In Aneen's December 31, 1990, balance sheet, the balance for unearned subscription revenue should be

a. $495,000
b. $470,000
c. $465,000
d. $340,000

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

a. $50,000
b. $45,000
c. $25,588
d. $0

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$150,000</td>
</tr>
<tr>
<td>1991</td>
<td>225,000</td>
</tr>
<tr>
<td>1992</td>
<td>100,000</td>
</tr>
</tbody>
</table>

What amount should be reported as unearned service contract revenues in Ryan's December 31, 1989 balance sheet?

a. $540,000
b. $475,000
c. $295,000
d. $245,000

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

<table>
<thead>
<tr>
<th>Installment sales</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular sales</td>
<td>600,000</td>
</tr>
<tr>
<td>Cost of installment sales</td>
<td>500,000</td>
</tr>
<tr>
<td>Cost of regular sales</td>
<td>300,000</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>100,000</td>
</tr>
<tr>
<td>Collections on installment sales</td>
<td>200,000</td>
</tr>
</tbody>
</table>

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

1M89#31. On December 31, 1989, Bain Corp. sold a machine to Ryan and simultaneously leased it back for one year. Pertinent information at this date follows:
- Sales price $360,000
- Carrying amount 330,000
- Present value of reasonable lease rentals ($3,000 for 12 months @ 12%) 34,100
- Estimated remaining useful life 12 years

In Bain’s December 31, 1989 balance sheet, the deferred revenue from the sale of this machine should be
a. $34,100
b. $30,000
c. $4,100
d. $0

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

<table>
<thead>
<tr>
<th>Installment sales</th>
<th>$800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of installment sales</td>
<td>480,000</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>80,000</td>
</tr>
<tr>
<td>Collections on installment sales</td>
<td>300,000</td>
</tr>
</tbody>
</table>

The balance in the deferred gross profit account at December 31, 1988 should be
a. $120,000
b. $150,000
c. $200,000
d. $320,000

1M89#34. Dix Company sells magazine subscriptions for one- and two-year periods. Cash receipts from subscribers are credited to magazine subscriptions collected in advance. This account had a balance of $2,100,000 at December 31, 1988 before year-end adjustment. Outstanding subscriptions at December 31, 1988 expire as follows:
- During 1989 — $600,000
- During 1990 — 900,000
- During 1991 — 420,000
- During 1992 — 180,000
- During 1993 — 60,000

In its December 31, 1988 balance sheet, what amount should Dix report as the balance for magazine subscriptions collected in advance?
- $2,100,000
- $1,500,000
- $1,050,000
- $600,000

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

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

Under the installment sales method, what would be Rosson’s deferred gross profit at December 31, 1988?
- $120,000
- $90,000
- $80,000
- $60,000

1N88#20. At December 31, 1987, Raft Boutique had 1,000 gift certificates outstanding, which had been sold to customers during 1987 for $70 each. Raft operates on a gross margin of 60% of its sales. What amount of revenue pertaining to the 1,000 outstanding gift certificates should be deferred at December 31, 1987?
- $0
- $28,000
- $42,000
- $70,000

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

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

The leaseback is considered an operating lease

In Parke’s December 31, 1987 balance sheet, what amount should be included as deferred revenue on this transaction?
- $0
- $190,581
- $309,419
- $500,000

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Selected Questions

**1N87#13.** Kent Company sells magazine subscriptions for one- to three-year periods. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of $2,400,000 at December 31, 1986 before year-end adjustment. Outstanding subscriptions at December 31, 1986, expire as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Subscription Expiration Date</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>During 1987</td>
<td>$600,000</td>
</tr>
<tr>
<td>1988</td>
<td>During 1988</td>
<td>900,000</td>
</tr>
<tr>
<td>1989</td>
<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

**C. Deferred Income Tax Liabilities**

**1M81#41.** On June 30, 1990, Ank Corp. prepaid a $19,000 premium on an annual insurance policy. The premium payment was a tax deductible expense in Ank's 1990 cash basis tax return. The accrual basis income statement will report a $9,500 insurance expense in 1990 and 1991.
Accounting Practice

Ank elected early application of FASB Statement No. 96, Accounting for Income Taxes. Ank’s income tax rate is 30% in 1990 and 25% thereafter. In Ank’s December 31, 1990, balance sheet, what amount related to the insurance should be reported as a deferred income tax liability?

a. $5,700
b. $4,750
c. $2,850
d. $2,375

1M90#19. In its 1989 income statement, Noll Corp. reported depreciation of $400,000 and interest revenue on municipal obligations of $60,000. Noll reported depreciation of $550,000 on its 1989 income tax return. The difference in depreciation is the only temporary difference, and it will reverse equally over the next three years. Noll’s enacted income tax rates are 35% for 1989, 30% for 1990 and 25% for 1991 and 1992. Noll elected early application of FASB Statement No. 96, Accounting for Income Taxes. What amount should be included in the deferred income tax liability in Noll’s December 31, 1989 balance sheet?

a. $40,000  
b. $52,500  
c. $63,000  
d. $73,500

1M90#20. Cory, Inc. uses the accrual method of accounting for financial reporting purposes and appropriately uses the installment method of accounting for income tax purposes. Installment income of $250,000 will be collected in the following years when the enacted tax rates are:

<table>
<thead>
<tr>
<th>Collection of income</th>
<th>Enacted tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>$25,000 35%</td>
</tr>
<tr>
<td>1990</td>
<td>50,000 30%</td>
</tr>
<tr>
<td>1991</td>
<td>75,000 30%</td>
</tr>
<tr>
<td>1992</td>
<td>100,000 25%</td>
</tr>
</tbody>
</table>

The installment income is Cory’s only temporary difference. Cory elected early application of FASB Statement No. 96, Accounting for Income Taxes. What amount should be included in the deferred income tax liability in Cory’s December 31, 1989 balance sheet?

a. $62,500  
b. $71,250  
c. $78,750  
d. $87,500

1M90#28. Tell Corp.’s 1989 income statement had pretax financial income of $38,000 in its first year of operations. Tell uses an accelerated cost recovery method on its tax return and straight-line depreciation for financial reporting.

The differences between the book and tax deductions for depreciation over the five-year life of the assets acquired in 1989, and the enacted tax rates for 1989 to 1993 are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Book over (under) tax</th>
<th>Tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>(8,000)</td>
<td>35%</td>
</tr>
<tr>
<td>1990</td>
<td>(13,000)</td>
<td>30%</td>
</tr>
<tr>
<td>1991</td>
<td>(3,000)</td>
<td>30%</td>
</tr>
<tr>
<td>1992</td>
<td>10,000</td>
<td>25%</td>
</tr>
<tr>
<td>1993</td>
<td>14,000</td>
<td>25%</td>
</tr>
</tbody>
</table>

There are no other temporary differences. Tell elected early application of FASB Statement No. 96, Accounting for Income Taxes. In Tell’s December 31, 1989 balance sheet, the gross noncurrent deferred income tax liability and the income taxes currently payable should be

<table>
<thead>
<tr>
<th>Gross noncurrent deferred income tax liability</th>
<th>Income taxes currently payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $6,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>b. $6,000</td>
<td>$10,500</td>
</tr>
<tr>
<td>c. $4,800</td>
<td>$9,000</td>
</tr>
<tr>
<td>d. $4,800</td>
<td>$10,500</td>
</tr>
</tbody>
</table>

1M90#32. Tara Corp. uses the equity method of accounting for its 40% investment in Flax, Inc.’s common stock. During 1989, Flax reported earnings of $750,000 and paid dividends of $250,000. Assume that:

- All the undistributed earnings of Flax will be distributed as dividends in future periods.
- The dividends received from Flax are eligible for the 80% dividends received deduction.
- There are no other temporary differences.
- Tara’s 1989 income tax rate is 30%.
- Enacted income tax rates after 1989 are 25%.

Tara elected early application of FASB Statement No. 96, Accounting for Income Taxes. In its December 31, 1989 balance sheet, the increase in the deferred income tax liability from the above transactions would be

a. $10,000  
b. $12,000  
c. $15,000  
d. $18,000

1M90#34. Huff Corp. began operations on January 1, 1988. Huff recognizes revenues from all sales under the accrual method for financial reporting purposes and appropriately uses the installment method for income tax purposes. Huff’s gross margin on installment sales under each method was as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Accrual method</th>
<th>Installment method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>$800,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>1989</td>
<td>1,300,000</td>
<td>700,000</td>
</tr>
</tbody>
</table>
Selected Questions

Huff elected early application of FASB Statement No. 96, Accounting for Income Taxes. Enacted income tax rates are 30% for 1989 and 25% thereafter. There are no other temporary differences. In Huff’s December 31, 1989 balance sheet, the deferred income tax liability should be
   a. $150,000
   b. $180,000
   c. $275,000
   d. $330,000

1M89#24. Frey Corp., a construction company, appropriately uses the completed contract method of accounting for income tax purposes. However, Frey uses the percentage-of-completion accounting method for financial statement purposes. Pertinent data at December 31, 1988, the close of Frey’s first year of operations, are:

<table>
<thead>
<tr>
<th>Date contract began</th>
<th>Estimated completion date</th>
<th>Income recognized in 1988 on each contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/1/88</td>
<td>9/1/89</td>
<td>$600,000</td>
</tr>
<tr>
<td>6/1/88</td>
<td>12/1/89</td>
<td>300,000</td>
</tr>
<tr>
<td>9/1/88</td>
<td>3/1/89</td>
<td>200,000</td>
</tr>
<tr>
<td>12/1/88</td>
<td>6/1/89</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Frey’s enacted income tax rates are 30% for 1988, 25% for 1989 and 20% for 1990. Frey elected early application of FASB Statement No. 96, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1988. What amount should be included in the deferred income tax liability at December 31, 1988 for these transactions?
   a. $360,000
   b. $330,000
   c. $285,000
   d. $240,000

1M89#37. On January 1, 1988, Lum, Inc. purchased a machine for $90,000 which will be depreciated $9,000 per year for financial statement reporting. For income tax reporting, Lum elected to expense $10,000 and to use straight-line depreciation which will allow a cost recovery deduction of $8,000 for 1988. Lum uses the liability method to account for temporary differences. Assume a present and future enacted income tax rate of 30%. What amount should be added to Lum’s deferred income tax liability for this temporary difference at December 31, 1988?
   a. $5,400
   b. $3,000
   c. $2,700
   d. $2,400

1M89#40. On January 1, 1988, Lund Corporation purchased 40% of the voting common stock of Glen, Inc. and appropriately accounts for its investment by the equity method. During 1988, Glen reported earnings of $225,000 and paid dividends of $75,000. Lund assumes that all of Glen’s undistributed earnings will be distributed as dividends in future periods when the enacted tax rate will be 30%. Ignore the dividend-received deduction. Lund’s current enacted income tax rate is 25%. Lund uses the liability method to account for temporary differences. The increase in Lund’s deferred income tax liability for this temporary difference is
   a. $45,000
   b. $37,500
   c. $27,000
   d. $18,000

1M89#41. Lane, Inc., which began operations on January 1, 1986, recognizes income from construction-type contracts under the percentage-of-completion method in its financial statements. Lane appropriately uses the completed contract method for income tax reporting. Reported income from construction-type contracts under each method is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage-of-completion</th>
<th>Completed contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>$600,000</td>
<td>$ —</td>
</tr>
<tr>
<td>1987</td>
<td>1,200,000</td>
<td>800,000</td>
</tr>
<tr>
<td>1988</td>
<td>1,700,000</td>
<td>1,400,000</td>
</tr>
</tbody>
</table>

For all of the above years and years to 1991 the enacted income tax rate is 30%, and there are no other temporary differences. At December 31, 1988, using the liability method, Lane should report a liability for deferred taxes of
   a. $90,000
   b. $210,000
   c. $300,000
   d. $390,000

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**Accounting Practice**

1990#42. Among the items reported on Cord, Inc.'s income statement for the year ended December 31, 1988 were the following:

- Amortization of goodwill $10,000
- Insurance premium on life of an officer with Cord as owner and beneficiary $5,000

Temporary differences amount to

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

D. Capitalized Lease Liability

1991#42. On January 1, 1990, Babson, Inc. leased two automobiles for executive use. The lease requires Babson to make five annual payments of $13,000 beginning January 1, 1990. At the end of the lease term, December 31, 1994, Babson guarantees the residual value of the automobiles will total $10,000. The lease qualifies as a capital lease. The interest rate implicit in the lease is 9%. Present value factors for the 9% rate implicit in the lease are as follows:

For an annuity due with 5 payments 4.240
For an ordinary annuity with 5 payments 3.890
Present value of $1 for 5 periods 0.650

Babson's recorded capital lease liability immediately after the first required payment should be

a. $48,620
b. $44,070
c. $35,620
d. $31,070

1991#43. On January 1, 1990, Blaugh Co. signed a long-term lease for an office building. The terms of the lease required Blaugh to pay $10,000 annually, beginning December 30, 1990, and continuing each year for 30 years. The lease qualifies as a capital lease. On January 1, 1990, the present value of the lease payments is $112,500 at the 8% interest rate implicit in the lease. In Blaugh's December 31, 1990, balance sheet, the capital lease liability should be

a. $102,500
b. $111,500
c. $112,500
d. $290,000

1990#21. On December 31, 1989, Neal, Inc. leased machinery with a fair value of $105,000 from Frey Rentals Co. The agreement is a six-year noncancelable lease requiring annual payments of $20,000 beginning December 31, 1989. The lease is appropriately accounted for by Neal as a capital lease. Neal's incremental borrowing rate is 11%. Neal knows the interest rate implicit in the lease payments is 10%.

- The present value of an annuity due of 1 for 6 years at 10% is 4.7908.
- The present value of an annuity due of 1 for 6 years at 11% is 4.6959.

In its December 31, 1989 balance sheet, Neal should report a lease liability of

a. $75,816
b. $85,000
c. $93,918
d. $95,816

1990#22. On December 31, 1988, Roe Co. leased a machine from Colt for a five-year period. Equal annual payments under the lease are $105,000 (including $5,000 annual executory costs) and are due on December 31 of each year. The first payment was made on December 31, 1988, and the second payment was made on December 31, 1989. The five lease payments are discounted at 10% over the lease term. The present value of minimum lease payments at the inception of the lease and before the first annual payment was $417,000. The lease is appropriately accounted for as a capital lease by Roe. In its December 31, 1989 balance sheet, Roe should report a lease liability of

a. $317,000
b. $315,000
c. $285,300
d. $248,700

1990#33. On December 31, 1988, Ball Co. leased a machine from Cook for a ten-year period expiring December 30, 1998. Annual payments of $100,000 are due on December 31. The first payment was made on December 31, 1988, and the second payment was made on December 31, 1989. The present value at the inception of the lease for the ten lease payments discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Ball. In its December 31, 1989 balance sheet, Ball should report a lease liability of

a. $643,600
b. $608,400
c. $533,600
d. $518,400

1990#35. On January 1, 1989, Day Corp. entered into a 10-year lease agreement with Ward, Inc. for industrial equipment. Annual lease payments of $10,000 are payable at the end of each year. Day knows that the lessor expects a 10% return on the lease. Day has a 12% incremental borrowing rate. The equipment is expected to have an estimated useful life of 10 years. In addition, a third party has guaranteed to pay Ward a residual value of $5,000 at the end of the lease.

The present value of an ordinary annuity of $1 at

<table>
<thead>
<tr>
<th>Rate</th>
<th>Present Value Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>6.1446</td>
</tr>
<tr>
<td>12%</td>
<td>5.6502</td>
</tr>
</tbody>
</table>

The present value of $1 at

<table>
<thead>
<tr>
<th>Rate</th>
<th>Present Value Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>.3855</td>
</tr>
<tr>
<td>12%</td>
<td>.3220</td>
</tr>
</tbody>
</table>
In Day's October 31, 1989 balance sheet, the principal amount of the lease obligation was

a. $63,374  
b. $61,446  
c. $58,112  
d. $56,502

1N88#22. On December 30, 1987, Bliss Corp. leased equipment under a capital lease for a period of 12 years, contracting to pay $100,000 annual rent on December 31, 1987 and on December 31 for each of the next 9 years. The capital lease liability was appropriately recorded at $681,600 on December 30, 1987 before the first payment. The useful life of the equipment coincided with the lease term. The interest rate implicit in the lease is 10%. In recording the December 31, 1988 payment, Bliss should reduce the capital lease liability by

a. $68,160  
b. $58,160  
c. $56,800  
d. $41,840

1N88#27. On December 30, 1988, Haber Co. leased a new machine from Gregg Corp. The following data relate to the lease transaction at the inception of the lease:

<table>
<thead>
<tr>
<th>Lease term</th>
<th>10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual rental payable at the end of each lease year</td>
<td>$100,000</td>
</tr>
<tr>
<td>Useful life of machine</td>
<td>12 years</td>
</tr>
<tr>
<td>Implicit interest rate</td>
<td>10%</td>
</tr>
<tr>
<td>Present value of an annuity of 1 in advance for 10 periods at 10%</td>
<td>6.76</td>
</tr>
<tr>
<td>Present value of annuity of 1 in arrears for 10 periods at 10%</td>
<td>6.15</td>
</tr>
<tr>
<td>Fair value of the machine</td>
<td>$700,000</td>
</tr>
</tbody>
</table>

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

a. $0  
b. $615,000  
c. $630,000  
d. $676,000

1N88#44. Beal, Inc. intends to lease a machine from Paul Corp. Beal's incremental borrowing rate is 14%. The prime rate of interest is 8%. Paul's implicit rate in the lease is 10%, which is known to Beal. Beal computes the present value of the minimum lease payments using

a. 8%  
b. 10%  
c. 12%  
d. 14%

1N88#22. On January 2, 1987, Ashe Company entered into a ten-year noncancelable lease as lessee, requiring annual payments of $200,000 payable at the beginning of each year. Ashe's incremental borrowing rate is 14%, while the lessor's implicit interest rate, known to Ashe, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%, and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Ashe should record a lease liability of

a. $1,266,000  
b. $1,190,000  
c. $1,066,000  
d. $0

1N88#29. On December 31, 1986, Evan Company leased a machine from Ryan for a ten-year period expiring December 30, 1996. Equal annual payments under the lease are $100,000 and are due on December 31 of each year. The first payment was made on December 31, 1986, and the second payment was made on December 31, 1987. The present value at December 31, 1986, of the ten lease payments over the lease term discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Evan. In its December 31, 1987 balance sheet, Evan should report a total lease liability of

a. $800,000  
b. $643,600  
c. $533,600  
d. $518,400

1N88#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:

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

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

1N88#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 $608,400 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 straight-line 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. $60,840

1M87#23. On December 30, 1986, Frey Company leased equipment from Hull. Pertinent lease transaction data are as follows:

- The estimated seven-year useful equipment life coincides with the lease term.
- The first of the seven equal annual $200,000 lease payments was paid on December 31, 1986.
- Hull's implicit interest rate of 12% is known to Frey.
- Frey's incremental borrowing rate is 14%.
- Present values of an annuity of 1 in advance for seven periods are 5.11 at 12%, and 4.89 at 14%, respectively.

At inception of the lease, Frey should record a capitalized lease liability of

a. $1,400,000  
b. $1,022,000  
c. $ 978,000  
d. $0

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

<table>
<thead>
<tr>
<th>Lease term</th>
<th>12 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual rental payable at beginning of each year</td>
<td>$100,000</td>
</tr>
<tr>
<td>Useful life of machine</td>
<td>15 years</td>
</tr>
<tr>
<td>Implicit interest rate</td>
<td>12%</td>
</tr>
<tr>
<td>Present value of an annuity of 1 in advance for 12 periods at 12%</td>
<td>6.94</td>
</tr>
</tbody>
</table>

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

E. Bonds Payable

1M91#46. On December 31, 1990, Cobb issued 2,000 of its 10%, $1,000 bonds at 99. The issuance price established a bond discount of $20,000. In connection with the sale of these bonds, Cobb paid the following expenses:

- Legal and accounting fees $45,000
- Printing of the prospectus 55,000
- Underwriting fees 85,000

In Cobb's December 31, 1990, balance sheet, bond issue costs should be reported as

a. $120,000  
b. $130,000  
c. $160,000  
d. $185,000

1M91#47. Hancock Co.'s December 31, 1990, balance sheet contained the following items in the long-term liabilities section:

Unsecured

9.375% registered bonds ($25,000 maturing annually beginning in 1994) $275,000
11.5% convertible bonds, callable beginning in 1999, due 2010 125,000

Secured

9.875% guaranty security bonds, due 2010 $250,000
10.0% commodity backed bonds ($50,000 maturing annually in 1995) 200,000

What are the total amounts of serial bonds and debenture bonds?

<table>
<thead>
<tr>
<th>Serial bonds</th>
<th>Debenture bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $475,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>b. $475,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>c. $450,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>d. $200,000</td>
<td>$650,000</td>
</tr>
</tbody>
</table>

1N90#23. On March 1, 1990, Cain Corp. issued at 103 plus accrued interest, two hundred of its 9%, $1,000 bonds. The bonds are dated January 1, 1990 and mature on January 1, 2000. Interest is payable semiannually on January 1 and July 1. Cain paid bond issue costs of
$10,000. Cain should realize net cash receipts from the bond issuance of
a. $216,000
b. $209,000
c. $206,000
d. $199,000

1M90#24. On June 30, 1990, Huff Corp. issued at 99, one thousand of its 8%, $1,000 bonds. The bonds were issued through an underwriter to whom Huff paid bond issue costs of $35,000. On June 30, 1990, Huff should report the bond liability at
a. $95,000
b. $990,000
c. $1,000,000
d. $1,025,000

1M90#25. On January 1, 1989, Wolf Corp. issued its 10% bonds in the face amount of $1,000,000, which mature on January 1, 1999. The bonds were issued for $1,135,000 to yield 8%, resulting in bond premium of $135,000. Wolf uses the interest method of amortizing bond premium. Interest is payable annually on December 31. At December 31, 1989, Wolf's adjusted unamortized bond premium should be
a. $135,000
b. $125,800
c. $121,500
d. $101,500

1M90#26. On April 1, 1989, Ward Corp. issued $750,000 of 10% nonconvertible bonds at 102 that are due on March 1, 1999. Each $1,000 bond was issued with 40 detachable stock warrants, each of which entitled the bondholder to purchase one share of Ward $10 par common stock for $25. On April 1, 1989, the market value of Ward's common stock was $20 per share, and the market value of each warrant was $4. What amount of the proceeds from the bond issue should Ward record as an increase in stockholders' equity?
 a. $15,000
b. $120,000
c. $300,000
d. $750,000

1M90#27. On June 30, 1989, Town Co. had outstanding 8%, $2,000,000 face amount, 15-year bonds maturing on June 30, 1999. Interest is payable on June 30 and December 31. The unamortized balances in the bond discount and deferred bond issue costs accounts on June 30, 1989 were $70,000 and $20,000, respectively. On June 30, 1989, Town acquired all of these bonds at 94 and retired them. What net carrying amount should be used in computing gain or loss on this early extinguishment of debt?
 a. $1,980,000
b. $1,930,000
c. $1,910,000
d. $1,880,000

1M90#26. On July 1, 1989, Howe Corp. issued 300 of its 10%, $1,000 bonds at 99 plus accrued interest. The bonds are dated April 1, 1989 and mature on April 1, 1999. Interest is payable semiannually on April 1 and October 1. What amount did Howe receive from the bond issuance?
 a. $304,500
b. $300,000
c. $297,000
d. $289,500

1M90#27. During 1989, Eddy Corp. incurred the following costs in connection with the issuance of bonds:
Printing and engraving $30,000
Legal fees 160,000
Fees paid to independent accountants for registration information 20,000
Commissions paid to underwriter 300,000

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?
 a. $510,000
b. $480,000
c. $300,000
d. $210,000

1M90#28. On January 1, 1989, Kay Inc. issued its 10% bonds in the face amount of $400,000, which mature on January 1, 1999. The bonds were issued for $354,000 to yield 12%, resulting in a bond discount of $46,000. Kay uses the interest method of amortizing bond discount. Interest is payable semiannually on July 1 and January 1. At June 30, 1989, Kay's unamortized bond discount would be
 a. $46,000
b. $44,760
c. $43,700
d. $42,000

1M90#29. On January 1, 1984, Fox Corp. issued 1,000 of its 10%, $1,000 bonds for $1,040,000. These bonds were to mature on January 1, 1994 but were callable at 101 any time after December 31, 1987. Interest was payable semiannually on July 1 and January 1. On July 1, 1989, Fox called all of the bonds and retired them. Bond premium was amortized on a straight-line basis. Before income taxes, Fox's gain or loss in 1989 on this early extinguishment of debt was
 a. $30,000 gain.
b. $12,000 gain.
c. $10,000 loss.
d. $8,000 gain.

1M90#30. On June 30, 1989, Hamm Corp. had outstanding $2,000,000 face amount of 8% convertible bonds maturing on June 30, 1994. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 40 shares of Hamm's $20 par common stock. After amortization through June 30, 1989, the unamortized balance in the premium on bonds payable
account was $50,000. On June 30, 1989, all of the bonds were converted when Hamm's common stock had a market price of $30 per share. Under the book value method, what amount should Hamm credit to additional paid-in capital in recording the conversion?

- a. $350,000
- b. $400,000
- c. $450,000
- d. $800,000

On January 1, 1989, Pine Corp. sold 200 of its 8%, $1,000 bonds at 97 plus accrued interest. The bonds are dated October 1, 1988 and mature on October 1, 1998. Interest is payable semiannually on April 1 and October 1. Accrued interest for the period October 1, 1988 to January 1, 1989 amounted to $4,000. On January 1, 1989, Pine should report bonds payable, net of discount, at

- a. $196,000
- b. $194,150
- c. $194,000
- d. $190,150

On May 1, Kreal Corp. issued $1,000,000, 20-year, 10% bonds for $1,075,000. Each $1,000 bond had a detachable warrant eligible for the purchase of one share of Kreal's $50 par value common stock for $60. Immediately after the bonds were issued, Kreal's securities had the following market values:

- 10% bond without warrant $1,050
- Warrant 25
- Common stock, $50 par value 65

What amount of the bond issue proceeds should Kreal record as an increase in stockholders' equity?

- a. $50,000
- b. $25,000
- c. $5,000
- d. $0

On January 1, 1989, Carrow, Inc. issued its 10% bonds in the face amount of $1,000,000 that mature on January 1, 1999. The bonds were issued for $886,000 to yield 12%, resulting in bond discount of $114,000. Carrow uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1989, Carrow should report bond interest expense at

- a. $56,840
- b. $55,700
- c. $53,160
- d. $50,000

Faber, Inc. had outstanding 10%, $1,000,000 face amount convertible bonds maturing on December 31, 1993, on which interest is paid June 30 and December 31. After amortization through June 30, 1989, the unamortized balance in the bond discount account was $30,000. On that date, all of these bonds were converted into 40,000 shares of $20 par value common stock. Faber incurred expenses of $10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Faber should credit additional paid-in capital for

- a. $160,000
- b. $170,000
- c. $180,000
- d. $230,000

On February 1, 1986, Davis Corp. issued 12%, $1,000,000 face amount, 10-year bonds for $1,117,000. Davis reacquired all of these bonds at 102, plus accrued interest, on May 1, 1989 and retired them. Unamortized bond premium on that date was $78,000. Before income taxes, what was Davis' gain on the bond retirement?

- a. $97,000
- b. $58,000
- c. $39,000
- d. $19,000

On April 1, 1988, Fox, Inc. issued 400 of its 10%, $1,000 bonds at 97 plus accrued interest. The bonds are dated January 1, 1988 and mature on January 1, 1998. Interest is payable semiannually on January 1 and July 1. What amount of cash would Fox receive from the bond issuance?

- a. $378,000
- b. $388,000
- c. $393,000
- d. $398,000

On July 1, 1987, Cobb, Inc. issued 9% bonds in the face amount of $1,000,000, which mature on July 1, 1997. The bonds were issued for $939,000 to yield 10%, resulting in a bond discount of $61,000. Cobb uses the interest method of amortizing bond discount. Interest is payable annually on June 30. At June 30, 1989, Cobb's unamortized bond discount should be

- a. $52,810
- b. $51,000
- c. $48,800
- d. $43,000

On June 30, 1988, Eddy Corp. had outstanding 8%, $2,000,000 face amount convertible bonds maturing on June 30, 1998. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 40 shares of Eddy's $20 par common stock. After amortization through June 30, 1988, the unamortized balance in the premium on bonds payable account was $50,000. On June 30, 1988, 1,000 bonds were converted when Eddy's common stock had a market price of $30 per share. Under the book value method, what amount should Eddy credit to additional paid-in capital in recording the conversion?

- a. $425,000
- b. $400,000
- c. $225,000
- d. $200,000
Selected Questions

1M99#49. On July 1, 1982, Flax Corporation issued $2,000,000 of its 9%, $1,000 callable bonds for $1,920,000. The bonds are dated July 1, 1982 and mature on July 1, 1992. Interest is payable semiannually on January 1 and July 1. Flax uses the straight-line method of amortizing bond discount. The bonds can be called by the issuer at 101 at any time after June 30, 1987.

On July 1, 1988, Flax called in all of the bonds and retired them. Before income taxes, how much loss should Flax report on this early extinguishment of debt for the year ended December 31, 1988?

a. $20,000
b. $52,000
c. $68,000
d. $100,000

1N88#32. On March 1, 1988, Case Corp. issued $1,000,000 of 10% nonconvertible bonds at 103, due on February 28, 1998. Each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the holder to purchase, for $50, one share of Case common stock, par value $25. On March 1, 1988, the quoted market value of each warrant was $4. What amount of the bond issue proceeds should Case record as an increase in stockholders' equity?

a. $120,000
b. $90,000
c. $30,000
d. $0

1N88#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

1N88#38. On April 30, 1988, Witt Corp. had outstanding 8%, $1,000,000 face amount, convertible bonds maturing on April 30, 1992. Interest is payable on April 30 and October 31. On April 30, 1988, all these bonds were converted into 40,000 shares of $20 par common stock. On the date of conversion:

- Unamortized bond discount was $30,000.
- Each bond had a market price of $1,080.
- Each share of stock had a market price of $28.

Under the book value method, what amount should Witt record as a loss on conversion of bonds?

a. $150,000
b. $110,000
c. $30,000
d. $0

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

10% bond without warrant $1,040
Warrant 20
Common stock, $50 par 56

What amount should Hill credit to premium on bonds payable?

a. $120,000
b. $80,000
c. $40,000
d. $0

1N87#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.

1N87#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>Present value of 1 for 10 periods</th>
<th>At 8%</th>
<th>At 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.463</td>
<td>0.386</td>
<td></td>
</tr>
</tbody>
</table>

Present value of an ordinary annuity of 1 for 10 periods 6.710 6.145

The total issue price (rounded) of the bonds was

a. $1,000,000
b. $980,000
c. $920,000
d. $880,000

1N87#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
Accounting Practice

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

a. $3,800  
b. $3,100  
c. $2,480  
d. $1,900

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

a. $200,000  
b. $225,000  
c. $250,000  
d. $400,000

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

a. $1,500,000  
b. $240,000  
c. $60,000  
d. $0

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

a. $116,000  
b. $194,000  
c. $234,000  
d. $236,000

F. Contingent Liabilities and Commitments

1N90#28. Dunn Trading Stamp Co. records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Dunn's past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Dunn's liability for stamp redemptions was $6,000,000 at December 31, 1988. Additional information for 1989 is as follows:

- Stamp service revenue from stamps sold to licensees $4,000,000
- Cost of redemptions (stamps sold prior to 1/1/89) 2,750,000

If all the stamps sold in 1989 were presented for redemption in 1990, the redemption cost would be $2,250,000. What amount should Dunn report as a liability for stamp redemptions at December 31, 1989?

a. $7,250,000  
b. $5,500,000  
c. $5,050,000  
d. $3,250,000

1N90#30. During 1988, Rex Co. introduced a new product carrying a two-year warranty against defects. The estimated warranty costs related to dollar sales are 2% within 12 months following sale and 4% in the second 12 months following sale. Sales and actual warranty expenditures for the years ended December 31, 1988 and 1989 are as follows:

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Selected Questions

<table>
<thead>
<tr>
<th>Sales</th>
<th>Actual warranty expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>$600,000</td>
</tr>
<tr>
<td>1,000,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>$1,600,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

At December 31, 1989, Rex should report an estimated warranty liability of
a. $0
b. $10,000
c. $45,000
d. $57,000

1M90#59. During 1989, Tedd Co. became involved in a tax dispute with the IRS. At December 31, 1989, Tedd’s tax advisor believed that an unfavorable outcome was probable. A reasonable estimate of additional taxes was $400,000 but could be as much as $600,000. After the 1989 financial statements were issued, Tedd received and accepted an IRS settlement offer of $450,000. What amount of accrued liability should Tedd have reported in its December 31, 1989 balance sheet?

a. $400,000
b. $450,000
c. $500,000
d. $600,000

1M90#60. On November 25, 1989, an explosion occurred at a Rex Co. plant causing extensive property damage to area buildings. By March 10, 1990, claims had been asserted against Rex. Rex’s management and counsel concluded that it is probable Rex will be responsible for damages, and that $3,500,000 would be a reasonable estimate of its liability. Rex’s $10,000,000 comprehensive public liability policy has a $500,000 deductible clause. Rex’s December 31, 1989 financial statements, issued on March 25, 1990, should report this item as
a. A footnote disclosure indicating the probable loss of $3,500,000.
b. An accrued liability of $3,500,000.
c. An accrued liability of $500,000.
d. A footnote disclosure indicating the probable loss of $500,000.

1N89#32. On November 10, 1988, a Garry Corp. truck was in an accident with an auto driven by Dacey. On January 10, 1989, Garry received notice of a lawsuit seeking $800,000 in damages for personal injuries suffered by Dacey. Garry Corp.’s counsel believes it is reasonably possible that Dacey will be awarded an estimated amount in the range between $250,000 and $500,000, and that $400,000 is a better estimate of potential liability than any other amount. Garry’s accounting year ends on December 31, and the 1988 financial statements were issued on March 6, 1989. What amount of loss should Garry accrue at December 31, 1988?

a. $0
b. $250,000
c. $400,000
d. $500,000

1N89#33. In packages of its products, Curran Co. includes coupons that may be presented at retail stores to obtain discounts on other Curran products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Curran honors requests for coupon redemption by retailers up to three months after the consumer expiration date. Curran estimates that 70% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Curran during 1988 is as follows:

<table>
<thead>
<tr>
<th>Consumer expiration date</th>
<th>Total face amount of coupons issued</th>
<th>Total payments to retailers as of 12/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/88</td>
<td>$600,000</td>
<td>220,000</td>
</tr>
</tbody>
</table>

What amount should Curran report as a liability for unredeemed coupons at December 31, 1988?

a. $0
b. $200,000
c. $242,000
d. $308,000

1M89#43. On December 31, 1988, Mith Co. was a defendant in a pending lawsuit. The suit arose from the alleged defect of a product that Mith sold in 1986. In the opinion of Mith’s attorney, it is probable that Mith will have to pay $50,000, and it is reasonably possible that Mith will have to pay $60,000 as a result of this lawsuit. In its 1988 financial statements, Mith would report
a. An accrued liability of $50,000 only.
b. An accrued liability of $50,000 and would disclose a contingent liability of an additional $10,000.
c. An accrued liability of $60,000 only.
d. No information about this lawsuit.

1N88#25. In packages of its products, the Kent Food Company includes coupons which may be presented to grocers for discounts on certain products of Kent on or before a stated expiration date. The grocers are reimbursed when they send the coupons to Kent. In Kent’s experience, 40% of such coupons are redeemed, and one month generally elapses between the date a grocer receives a coupon from a consumer and the date Kent receives it. During 1987, Kent issued two series of coupons as follows:

<table>
<thead>
<tr>
<th>Issued of</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

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**Accounting Practice**

**1M86#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></th>
<th>Sales</th>
<th>Actual warranty expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>$300,000</td>
<td>$4,500</td>
</tr>
<tr>
<td>1987</td>
<td>$550,000</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td><strong>$850,000</strong></td>
<td><strong>$19,500</strong></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

**1M88#41.** On December 31, 1987, Beal Company was involved in a tax dispute with the IRS. Beal's tax counsel believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was $550,000, with a chance that the additional taxes could be as much as $850,000. After the 1987 financial statements were issued, Beal accepted an IRS settlement offer of $650,000. What amount of additional taxes should have been charged to income in 1987?

a. $850,000  
b. $650,000  
c. $550,000  
d. $0

**1M87#31.** Kent Corp. carries $10,000,000 comprehensive public liability insurance with a $200,000 deductible clause. A suit for personal injury damages was brought against Kent in 1986. Kent's counsel believes it probable that the insurance company will settle out of court for an estimated amount of $350,000. At December 31, 1986, Kent should report an accrued liability of

a. $350,000  
b. $200,000  
c. $150,000  
d. $0

**1M87#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

**1M87#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.

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

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

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

A. Preferred and Common Stock

2M91#4. The following accounts were among those reported on Luna Corp.'s balance sheet at December 31, 1990:

| Marketable securities (market value $140,000) | $80,000 |
| Preferred stock, $20 par value, 20,000 shares issued and outstanding | 400,000 |
| Additional paid-in capital on preferred stock | 30,000 |
| Retained earnings | 900,000 |

On January 20, 1991, Luna exchanged all of the marketable securities for 5,000 shares of Luna's preferred stock. Market values at the date of the exchange were $150,000 for the marketable securities and $30 per share for the preferred stock. The 5,000 shares of preferred stock were retired immediately after the exchange. Which of the following journal entries should Luna record in connection with this transaction?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Preferred stock</td>
<td>$100,000</td>
</tr>
<tr>
<td>Additional paid-in capital on preferred stock</td>
<td>7,500</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>42,500</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>$80,000</td>
</tr>
<tr>
<td>Gain on exchange of securities</td>
<td>70,000</td>
</tr>
<tr>
<td>b. Preferred stock</td>
<td>100,000</td>
</tr>
<tr>
<td>Additional paid-in capital on preferred stock</td>
<td>30,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>80,000</td>
</tr>
<tr>
<td>Additional paid-in capital from retirement of preferred stock</td>
<td>50,000</td>
</tr>
<tr>
<td>c. Preferred stock</td>
<td>150,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>80,000</td>
</tr>
<tr>
<td>Additional paid-in capital on preferred stock</td>
<td>70,000</td>
</tr>
<tr>
<td>d. Preferred stock</td>
<td>150,000</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>80,000</td>
</tr>
<tr>
<td>Gain on exchange of securities</td>
<td>70,000</td>
</tr>
</tbody>
</table>

2N89#12. In 1980, Rona Corp. issued 5,000 shares of $10 par value common stock for $100 per share. In 1988, Rona reacquired 2,000 of its shares at $150 per share from the estate of one of its deceased officers and immediately canceled these 2,000 shares. Rona uses the cost method in accounting for its treasury stock transactions. In connection with the retirement of these 2,000 shares, Rona should debit

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $20,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>b. $100,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>c. $180,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>d. $280,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

1N88#48. At December 31, 1987, Tara Corp.'s stockholders' equity consisted of the following:

| Preferred stock, $100 par, 10% noncumulative; 10,000 shares authorized, issued, and outstanding | $1,000,000 |
| Common stock, $20 par; 100,000 shares authorized; 80,000 shares issued and outstanding | 1,600,000 |
| Retained earnings | 600,000 |

The preferred stock has a liquidating value of $110 a share. At December 31, 1987, the book value per share of common stock is

| a. $20.00 |
| b. $22.00 |
| c. $26.25 |
| d. $27.50 |

1M88#42. Park Corp.'s stockholders' equity accounts at December 31, 1987 were as follows:

| Common stock, $20 par | $8,000,000 |
| Additional paid-in capital | 2,550,000 |
| Retained earnings | 1,275,000 |

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

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

2N89#11. Seco Corp. was incorporated on January 2, 1988. The following information pertains to Seco's common stock transactions:

<table>
<thead>
<tr>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2</td>
</tr>
<tr>
<td>February 1</td>
</tr>
<tr>
<td>July 1</td>
</tr>
<tr>
<td>December 1</td>
</tr>
</tbody>
</table>

AP-49
B. Additional Paid-in Capital

2M91#8. Earl was engaged by Farm Corp. to perform consulting services. Earl's compensation for these services consisted of 1,000 shares of Farm's $10 par value common stock, to be issued to Earl on completion of Earl's services. On the execution date of Earl's employment contract, Farm's stock had a market value of $40 per share. Six months later, when Earl's services were completed and the stock issued, the stock's market value was $50 per share. Farm's management estimated that Earl's services were worth $100,000 in cost savings to the company. As a result of this transaction, additional paid-in capital should increase by

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>$90,000</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>$40,000</td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

1N88#28. Ashe Corp. was organized on January 1, 1987, with authorized capital of 100,000 shares of $20 par value common stock. During 1987 Ashe had the following transactions affecting stockholders' equity:

January 10 — Issued 25,000 shares at $22 a share.
March 25 — Issued 1,000 shares for legal services when the fair value was $24 a share.
September 30 — Issued 5,000 shares for a tract of land when the fair value was $26 a share.

What amount should Ashe report for additional paid-in capital at December 31, 1987?

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>$84,000</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>$54,000</td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>$50,000</td>
<td></td>
</tr>
</tbody>
</table>

C. Retained Earnings and Dividends

2M91#7. In 1989, Elm Corp. bought 10,000 shares of Oil Corp. at a cost of $20,000. On January 15, 1990, Elm declared a property dividend of the Oil stock to shareholders of record on February 1, 1990, payable on February 15, 1990. During 1990, the Oil stock had the following market values:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>January 15</td>
<td>$25,000</td>
<td></td>
</tr>
<tr>
<td>February 1</td>
<td>26,000</td>
<td></td>
</tr>
<tr>
<td>February 15</td>
<td>24,000</td>
<td></td>
</tr>
</tbody>
</table>

The net effect of the foregoing transactions on retained earnings during 1990 should be a reduction of

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>$20,000</td>
</tr>
<tr>
<td>b</td>
<td>$24,000</td>
</tr>
<tr>
<td>c</td>
<td>$25,000</td>
</tr>
<tr>
<td>d</td>
<td>$26,000</td>
</tr>
</tbody>
</table>

2M91#12. The following stock dividends were declared and distributed by Sol Corp.:

<table>
<thead>
<tr>
<th>Percentage of common shares outstanding at declaration date</th>
<th>Fair value</th>
<th>Par value</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>$15,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>28</td>
<td>40,000</td>
<td>30,800</td>
</tr>
</tbody>
</table>

What aggregate amount should be debited to retained earnings for these stock dividends?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>$40,800</td>
</tr>
<tr>
<td>b</td>
<td>$45,800</td>
</tr>
<tr>
<td>c</td>
<td>$50,000</td>
</tr>
<tr>
<td>d</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

1N90#29. At December 31, 1989, Hull Corp. had the following marketable equity securities that were purchased during 1989, its first year of operations:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>In Current</td>
<td>Cost</td>
<td>Market</td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security A</td>
<td>$90,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>B</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$105,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>In Noncurrent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Security Y</td>
<td>$70,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Z</td>
<td>90,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$160,000</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

All market declines are considered temporary.

Valuation allowances at December 31, 1989 should be established with a corresponding charge against

<table>
<thead>
<tr>
<th></th>
<th>Stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>Stockholders' equity</td>
</tr>
<tr>
<td>a</td>
<td>$60,000</td>
</tr>
<tr>
<td>b</td>
<td>$30,000</td>
</tr>
<tr>
<td>c</td>
<td>$25,000</td>
</tr>
<tr>
<td>d</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

2M89#13. On July 1, 1988, Alto Corp. split its common stock 5 for 1 when the market value was $100 per share. Prior to the split, Alto had 10,000 shares of $10 par value common stock issued and outstanding. After the split, the par value of the stock

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Remained at $10</td>
</tr>
<tr>
<td>b</td>
<td>Was reduced to $8</td>
</tr>
<tr>
<td>c</td>
<td>Was reduced to $5</td>
</tr>
<tr>
<td>d</td>
<td>Was reduced to $2</td>
</tr>
</tbody>
</table>
Selected Questions

2N89#14. At December 31, 1987 and 1988, Tri Corp. had outstanding 2,000 shares of $100 par value 6% cumulative preferred stock and 10,000 shares of $10 par value common stock. At December 31, 1987, dividends in arrears on the preferred stock were $6,000. Cash dividends declared in 1988 totaled $22,000. What amounts were payable on each class of stock?

<table>
<thead>
<tr>
<th>Preferred stock</th>
<th>Common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $12,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>b. $16,000</td>
<td>$  6,000</td>
</tr>
<tr>
<td>c. $18,000</td>
<td>$  4,000</td>
</tr>
<tr>
<td>d. $22,000</td>
<td>$  0</td>
</tr>
</tbody>
</table>

2N89#15. The first examination of Rudd Corp.'s financial statements was made for the year ended December 31, 1988. The auditor found that Rudd had purchased another company in January 1986 and had recorded goodwill of $100,000 in connection with this purchase. It was determined that the goodwill had an estimated useful life of only five years because of obsolescence. No amortization of goodwill had ever been recorded. For the December 31, 1988 financial statements, Rudd should debit:

<table>
<thead>
<tr>
<th>Amortization expense</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$100,000</td>
</tr>
<tr>
<td>b. $20,000</td>
<td>$  40,000</td>
</tr>
<tr>
<td>c. $33,333</td>
<td>$    0</td>
</tr>
<tr>
<td>d. $60,000</td>
<td>$    0</td>
</tr>
</tbody>
</table>

2M89#2. Lind Corp. declared a cash dividend of $50,000 on March 10, 1989 to stockholders of record March 25, 1989, payable on April 5, 1989. As a result of this cash dividend, working capital

a. Decreased on March 10 by $50,000.
b. Decreased on March 25 by $50,000.
c. Decreased on April 5 by $50,000.
d. Did not change.

2M89#3. On May 1, 1989, Rhud Corp. declared and issued a 10% common stock dividend. Prior to this dividend, Rhud had 100,000 shares of $1 par value common stock issued and outstanding. The fair value of Rhud's common stock was $30 per share on May 1, 1989. As a result of this stock dividend, Rhud's total stockholders' equity

a. Increased by $300,000.
b. Decreased by $300,000.
c. Decreased by $18,000.
d. Did not change.

1N88#60. Bain Corp. owned 20,000 common shares of Tell Corp. purchased in 1983 for $180,000. On December 15, 1987, Bain declared a property dividend of all of its Tell Corp. shares on the basis of one share of Tell for every 10 shares of Bain common stock held by its stockholders. The property dividend was distributed on January 15, 1988. On the declaration date, the aggregate market price of the Tell shares held by Bain was $300,000. The entry to record the declaration of the dividend would include a debit to retained earnings (or property dividends declared) of

a. $0
b. $120,000
c. $180,000
d. $300,000

1M88#43. On January 5, 1988, Sardi Minerals Corp. declared a cash dividend of $600,000 to stockholders of record on January 21, 1988, and payable on February 11, 1988. The dividend is permissible under the laws of Sardi's state of incorporation. The following data pertain to 1987:

Net income for year ended 12/31/87 $190,000
Additional paid-in capital, 12/31/87 675,000
Retained earnings, 12/31/87 425,000

The $600,000 dividend includes a liquidating dividend of

a. $0
b. $175,000
c. $410,000
d. $485,000

1N87#34. On June 30, 1987, Dorr, Inc. declared and issued a 10% common stock dividend. Prior to the dividend, Dorr had 30,000 shares of $10 par common stock issued and outstanding. The market price of Dorr's common stock on June 30, 1987, was $27 per share. As a result of this stock dividend, by what amount should Dorr's total stockholders' equity increase or (decrease)?

a. ($81,000)
b. $51,000
c. $30,000
d. $0

1N87#34. During 1987, Paul Company discovered that the ending inventories reported on its financial statements were incorrect by the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Understatement/Overstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$60,000 understated</td>
</tr>
<tr>
<td>1986</td>
<td>75,000 overstated</td>
</tr>
</tbody>
</table>

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

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

D. Treasury Stock and Other Contra Accounts

2N89#16. The following information pertains to Plat Corp.'s long-term marketable equity securities portfolio:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Market value</td>
<td>90,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Differences between cost and market values are considered to be temporary. The decline in market value was properly accounted for at December 31, 1987. By what amount should the contra account — unrealized loss in long-term marketable equity securities — decrease from December 31, 1987 to December 31, 1988?

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

2M89#4. In 1988, Newt Corp. acquired 6,000 shares of its own $1 par value common stock at $18 per share. In 1989, Newt issued 3,000 of these shares at $25 per share. Newt uses the cost method to account for its treasury stock transactions. What accounts and amounts should Newt credit in 1989 to record the issuance of the 3,000 shares?

<table>
<thead>
<tr>
<th>Treasury stock</th>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
<th>Common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>$54,000</td>
<td>$21,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>$57,000</td>
<td>$24,000</td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>$60,000</td>
<td>$27,000</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>$63,000</td>
<td>$30,000</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

2M89#6. At December 31, 1987, Rama Corp. had 20,000 shares of $1 par value treasury stock that had been acquired in 1987 at $12 per share. In May 1988, Rama issued 15,000 of these treasury shares at $10 per share. The cost method is used to record treasury stock transactions. Rama is located in a state where laws relating to acquisition of treasury stock restrict the availability of retained earnings for declaration of dividends. At December 31, 1988, what amount should Rama show in notes to financial statements as a restriction of retained earnings as a result of its treasury stock transactions?

a. $5,000
b. $10,000
c. $60,000
d. $90,000

1N88#44. Day Corp. holds 10,000 shares of its $10 par value common stock as treasury stock reacquired in 1986 for $120,000. On December 12, 1988, Day reissued all 10,000 shares for $190,000. Under the cost method of accounting for treasury stock, the reissuance would result in a credit to

a. Capital stock of $100,000.
b. Retained earnings of $70,000.
c. Gain on sale of investments of $70,000.
d. Additional paid-in capital of $70,000.

E. Stock Options, Warrants, and Rights

2M91#5. Ray Corp. issued bonds with a face amount of $200,000. Each $1,000 bond contained detachable stock warrants for 100 shares of Ray's common stock. Total proceeds from the issue amounted to $240,000. The market value of each warrant was $2, and the market value of the bonds without the warrants was $196,000. The bonds were issued at a discount of

a. $0
b. $678
c. $4,000
d. $33,898

2M88#7. On January 1, 1987, Doro Corp. granted an employee an option to purchase 3,000 shares of Doro's $5 par value common stock at $20 per share. The option became exercisable on December 31, 1988, after the employee completed two years of service. The option was exercised on January 10, 1989. The market prices of Doro's stock were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1987</td>
<td>$30</td>
</tr>
<tr>
<td>December 31, 1988</td>
<td>50</td>
</tr>
<tr>
<td>January 10, 1989</td>
<td>45</td>
</tr>
</tbody>
</table>

For 1988, Doro should recognize compensation expense of

a. $45,000
b. $37,500
c. $15,000
d. $0

1N88#41. On January 1, 1987, Ward Corp. granted stock options to corporate executives for the purchase of 20,000 shares of the company's $20 par value common stock at 80% of the market price on the exercise date, December 28, 1987. All stock options were exercised on December 28, 1987. The quoted market prices of Ward's $20 par value common stock were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 1987</td>
<td>$45</td>
</tr>
<tr>
<td>December 28, 1987</td>
<td>60</td>
</tr>
</tbody>
</table>

As a result of the exercise of the stock options and the issuance of the common stock, Ward should record a credit to additional paid-in capital of

a. $800,000
b. $740,000
c. $560,000
d. $500,000
Selected Questions

1N87#40. On February 24, 1986, Bart Company purchased 2,000 shares of Winn Corp.'s newly issued 6% cumulative $75 par preferred stock for $152,000. Each share carried one detachable stock warrant entitling the holder to acquire at $10, one share of Winn no-par common stock. On February 25, 1986, the market price of the preferred stock ex-warrants was $72 a share and the market price of the stock warrants was $8 a warrant. On December 29, 1986, Bart sold all the stock warrants for $20,500. The gain on the sale of the stock warrants was

a. $0
b. $500
c. $4,500
d. $5,300

F. Reorganization and Change in Entity

2M91#13. On August 31, 1990, Wood Corp. issued 100,000 shares of its $20 par value common stock for the net assets of Pine, Inc., in a business combination accounted for by the purchase method. The market value of Wood's common stock on August 31 was $36 per share. Wood paid a fee of $160,000 to the consultant who arranged this acquisition. Costs of registering and issuing the equity securities amounted to $80,000. No goodwill was involved in the purchase. What amount should Wood capitalize as the cost of acquiring Pine's net assets?

a. $3,600,000
b. $3,680,000
c. $3,760,000
d. $3,840,000

2M91#14. Seco Corp. was forced into bankruptcy and is in the process of liquidating assets and paying claims. Unsecured claims will be paid at the rate of forty cents on the dollar. Hale holds a $30,000 noninterest-bearing note receivable from Seco collateralized by an asset with a book value of $35,000 and a liquidation value of $5,000. The amount to be realized by Hale on this note is

a. $5,000
b. $12,000
c. $15,000
d. $17,000

1N90#31. Kent Co. filed a voluntary bankruptcy petition on August 15, 1989, and the statement of affairs reflects the following amounts:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Book value</th>
<th>Estimated current value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets pledged with fully secured creditors</td>
<td>$300,000</td>
<td>$370,000</td>
</tr>
<tr>
<td>Assets pledged with partially secured creditors</td>
<td>$180,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Free assets</td>
<td>$420,000</td>
<td>$320,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$900,000</td>
<td>$810,000</td>
</tr>
</tbody>
</table>

Liabilities:

- Liabilities with priority: $70,000
- Fully secured creditors: $260,000
- Partially secured creditors: $200,000
- Unsecured creditors: $540,000

**Total Liabilities:** $1,070,000

Assume that the assets are converted to cash at the estimated current values and the business is liquidated. What amount of cash will be available to pay unsecured nonpriority claims?

a. $240,000
b. $280,000
c. $320,000
d. $360,000

2N89#18. The December 31, 1988 condensed balance sheet of Mason & Gross, a partnership, follows:

| Current assets | $125,000 |
| Equipment (net) | $15,000 |
| **Total assets** | $140,000 |
| Liabilities | $10,000 |
| Mason, Capital | $80,000 |
| Gross, Capital | $50,000 |
| **Total liabilities and capital** | $140,000 |

Market values at December 31, 1988 are as follows:

- Current assets: $90,000
- Equipment: $30,000
- Liabilities: $10,000

On January 2, 1989, the partnership was incorporated and 1,000 shares of $5 par value common stock were issued. What amount should be credited to additional contributed capital?

a. $0
b. $105,000
c. $125,000
d. $135,000

1N88#56. Howe, Inc. was organized to consolidate the resources of Ball Corp. and Cook Corp. in a business combination appropriately accounted for by the pooling of interests method. On January 1, 1988, Howe issued 60,000 shares of its $10 par value common stock for all of the outstanding capital stock of Ball and Cook. The equity account balances of Ball and Cook on this date were:

<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><strong>Total</strong></td>
<td>$280,000</td>
<td>$700,000</td>
<td>$980,000</td>
</tr>
</tbody>
</table>

AP-53
What is the balance in Howe's additional paid-in capital account immediately after the business combination?

- $0
- $65,000
- $115,000
- $380,000

1M88#44. Kent, Inc. has been forced into bankruptcy and has begun to liquidate. Unsecured claims will be paid at the rate of 40 cents on the dollar. Apex Co. holds a noninterest bearing note receivable from Kent in the amount of $100,000, collateralized by machinery with a liquidation value of $25,000. The total amount to be realized by Apex on this note receivable is

- $25,000
- $40,000
- $55,000
- $65,000

G. Partnerships

2M91#1. Abel and Carr formed a partnership and agreed to divide initial capital equally, even though Abel contributed $100,000 and Carr contributed $84,000 in identifiable assets. Under the bonus approach to adjust the capital accounts, Carr's unidentified asset should be debited for

- $46,000
- $16,000
- $8,000
- $0

2M91#2. Dunn and Grey are partners with capital account balances of $60,000 and $90,000, respectively. They agree to admit Zorn as a partner with a one-third interest in capital and profits, for an investment of $100,000, after revaluing the assets of Dunn and Grey. Goodwill to the original partners should be

- $0
- $33,333
- $50,000
- $66,667

2M91#3. The partnership agreement of Reid and Simm provides that interest at 10% per year is to be credited to each partner on the basis of weighted-average capital balances. A summary of Simm’s capital account for the year ended December 31, 1990, is as follows:

<table>
<thead>
<tr>
<th>Balance, January 1</th>
<th>$140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional investment, July 1</td>
<td>$40,000</td>
</tr>
<tr>
<td>Withdrawal, August 1</td>
<td>$(15,000)</td>
</tr>
<tr>
<td>Balance, December 31</td>
<td>$165,000</td>
</tr>
</tbody>
</table>

What amount of interest should be credited to Simm’s capital account for 1990?

- $15,250
- $15,375
- $16,500
- $17,250

2M91#17. Gow and Cubb formed a partnership on March 1, 1989 and contributed the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Gow</th>
<th>Cubb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Equipment (market value)</td>
<td>$50,000</td>
<td></td>
</tr>
</tbody>
</table>

The equipment was subject to a chattel mortgage of $10,000 that was assumed by the partnership. The partners agreed to share profits and losses equally. Cubb’s capital account at March 1, 1989 should be

- $40,000
- $45,000
- $50,000
- $60,000

2M91#19. Blau and Rubi are partners who share profits and losses in the ratio of 6:4, respectively. On May 1, 1989, their respective capital accounts were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Blau</th>
<th>Rubi</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$60,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

On that date, Lind was admitted as a partner with a one-third interest in capital and profits for an investment of $40,000. The new partnership began with total capital of $150,000. Immediately after Lind’s admission, Blau’s capital should be

- $50,000
- $54,000
- $56,667
- $60,000

2M91#20. Beck, the active partner in Beck & Cris, receives an annual bonus of 25% of partnership net income after deducting the bonus. For the year ended December 31, 1988, partnership net income before the bonus amounted to $300,000. Beck’s 1988 bonus should be

- $56,250
- $60,000
- $62,500
- $75,000

2M91#5. The following condensed balance sheet is presented for the partnership of Axel, Barr, and Cain, who share profits and losses in the ratio of 4:3:3, respectively:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Other assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$400,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Cash</th>
<th>Other assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$400,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Axel, capital</th>
<th>Barr, capital</th>
<th>Cain, capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$150,000</td>
<td>180,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>
The partners agreed to dissolve the partnership after selling the other assets for $200,000. Upon dissolution of the partnership, Axel should have received

a. $0
b. $40,000
c. $60,000
d. $70,000

**2M89#9.** On May 1, 1989, Cobb and Mott formed a partnership and agreed to share profits and losses in the ratio of 3:7, respectively. Cobb contributed a parcel of land that cost him $10,000. Mott contributed $40,000 cash. The land was sold for $18,000 on May 1, 1989, immediately after formation of the partnership. What amount should be recorded in Cobb’s capital account on formation of the partnership?

a. $18,000
b. $17,400
c. $15,000
d. $10,000

**2M89#10.** The partnership agreement of Donn, Eddy, and Farr provides for annual distribution of profit or loss in the following sequence:

- Donn, the managing partner, receives a bonus of 10% of profit.
- Each partner receives 6% interest on average capital investment.
- Residual profit or loss is divided equally.

Average capital investments for 1988 were:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Donn</td>
<td>$80,000</td>
</tr>
<tr>
<td>Eddy</td>
<td>50,000</td>
</tr>
<tr>
<td>Farr</td>
<td>30,000</td>
</tr>
</tbody>
</table>

What portion of the $100,000 partnership profit for 1988 should be allocated to Farr?

a. $28,600
b. $29,800
c. $35,133
d. $41,600

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:

**Assets**

<table>
<thead>
<tr>
<th></th>
<th>$ 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>250,000</td>
</tr>
<tr>
<td></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

**Liabilities and Capital**

<table>
<thead>
<tr>
<th></th>
<th>$ 60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td></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></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

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

**Cobb**

<table>
<thead>
<tr>
<th></th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>$40,000</td>
</tr>
<tr>
<td>c.</td>
<td>$55,000</td>
</tr>
<tr>
<td>d.</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

**Davis**

<table>
<thead>
<tr>
<th></th>
<th>$51,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>$45,000</td>
</tr>
<tr>
<td>c.</td>
<td>$33,000</td>
</tr>
<tr>
<td>d.</td>
<td>$36,000</td>
</tr>
</tbody>
</table>

**Eddy**

<table>
<thead>
<tr>
<th></th>
<th>$44,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>$35,000</td>
</tr>
<tr>
<td>c.</td>
<td>$22,000</td>
</tr>
<tr>
<td>d.</td>
<td>$24,000</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?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fox</td>
<td></td>
</tr>
<tr>
<td>Grimm</td>
<td></td>
</tr>
<tr>
<td>a.</td>
<td>$84,000</td>
</tr>
<tr>
<td>b.</td>
<td>$102,000</td>
</tr>
<tr>
<td>c.</td>
<td>$108,000</td>
</tr>
<tr>
<td>d.</td>
<td>$120,000</td>
</tr>
<tr>
<td></td>
<td>$56,000</td>
</tr>
<tr>
<td></td>
<td>$68,000</td>
</tr>
<tr>
<td></td>
<td>$72,000</td>
</tr>
<tr>
<td></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

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?

**Selected Questions**
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

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

Marr Corp. reported rental revenue of $2,210,000 in its cash basis federal income tax return for the year ended November 30, 1990. Additional information is as follows:

- Rents receivable — November 30, 1990: $1,060,000
- Rents receivable — November 30, 1989: 800,000
- Uncollectible rents written off during the fiscal year: 30,000

Under the accrual basis, Marr should report rental revenue of:

a. $1,920,000  
b. $1,980,000  
c. $2,440,000  
d. $2,500,000

Barr Corp. started a long-term construction project in 1990. The following data relate to this project:

- Contract price: $4,200,000  
- Costs incurred in 1990: 1,750,000  
- Estimated costs to complete: 1,750,000  
- Progress billings: 900,000  
- Collections on progress billings: 800,000

The project is accounted for by the percentage of completion method of accounting. In Barr's 1990 income statement, what amount of gross profit should be reported for this project?

a. $350,000  
b. $150,000  
c. $133,333  
d. $100,000

The mortgage is payable in nine annual installments of $300,000 beginning December 31, 1990, plus interest of 10%. The December 31, 1990, installment was paid as scheduled, together with interest of $270,000. Ryan uses the cost recovery method to account for the sale. What amount of income should Ryan recognize in 1990 from the real estate sale and its financing?

a. $570,000  
b. $370,000  
c. $270,000  
d. $0

Huff Co. acquired 30% of the voting common stock of Flax, Inc. on January 1, 1990, for $100,000. Huff has the ability to exercise significant influence over operating and financial policies of Flax. During 1990, Flax earned $40,000 and paid dividends of $25,000. Before income taxes, Huff should include what amount in its 1990 income statement pertaining to this investment?

a. $40,000  
b. $25,000  
c. $12,000  
d. $7,500

Tara owns an office building and leases the offices under a variety of rental agreements involving rent paid in advance monthly or annually. Not all tenants make timely payments of their rent. Tara's balance sheets contained the following data:

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rentals receivable</td>
<td>$9,600</td>
<td>$12,400</td>
</tr>
<tr>
<td>Unearned rentals</td>
<td>32,000</td>
<td>24,000</td>
</tr>
</tbody>
</table>

During 1990, Tara received $80,000 cash from tenants. What amount of rental revenue should Tara record for 1990?

a. $90,800  
b. $85,200  
c. $74,800  
d. $69,200

In November and December 1989, Dorr Co., a newly organized magazine publisher, received $72,000 for 1,000 three-year subscriptions at $24 per year, starting with the January 1990 issue. Dorr elected
Selected Questions

to include the entire $72,000 in its 1989 income tax return. What amount should Dorr report in its 1989 income statement for subscriptions revenue?

a. $0  
b. $ 4,000  
c. $24,000  
d. $72,000

1N90#33. Winn Co. manufactures equipment that is sold or leased. On December 31, 1989, Winn leased equipment to Bart for a five-year period ending December 31, 1994, at which date ownership of the leased asset will be transferred to Bart. Equal payments under the lease are $22,000 (including $2,000 executory costs) and are due on December 31 of each year. The first payment was made on December 31, 1989. Collectibility of the remaining lease payments is reasonably assured, and Winn has no material cost uncertainties. The normal sales price of the equipment is $77,000, and cost is $60,000. For the year ended December 31, 1989, what amount of income should Winn realize from the lease transaction?

a. $17,000  
b. $22,000  
c. $23,000  
d. $33,000

1N90#34. On January 1, 1988, Rex Co. sold a used machine to Lake, Inc. for $525,000. On this date, the machine had a depreciated cost of $367,500. Lake paid $75,000 cash on January 1, 1988 and signed a $450,000 note bearing interest at 10%. The note was payable in three annual installments of $150,000 beginning January 1, 1989. Rex appropriately accounted for the sale under the installment method. Lake made a timely payment of the first installment on January 1, 1989 of $195,000, which included interest of $45,000 to date of payment. At December 31, 1989, Rex has deferred gross profit of

a. $105,000  
b. $ 99,000  
c. $ 90,000  
d. $ 76,500

1N90#35. On January 1, 1988, Mill Co. exchanged equipment for a $200,000 noninterest bearing note due on January 1, 1991. The prevailing rate of interest for a note of this type at January 1, 1988 was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1989 income statement?

a. $0  
b. $15,000  
c. $16,500  
d. $20,000

1N90#36. Day Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:

• A stock dividend of 400 shares from Parr Corp. on July 25, 1989 when the market price of Parr's shares was $20 per share. Day owns less than 1% of Parr's common stock.

• A cash dividend of $15,000 from Lark Corp. in which Day owns a 25% interest. A majority of Lark's directors are also directors of Day.

What amount of dividend revenue should Day report in its 1989 income statement?

a. $23,000  
b. $15,000  
c. $ 8,000  
d. $0

1N90#37. On January 1, 1989, Wren Co. leased a building to Brill under an operating lease for ten years at $50,000 per year, payable the first day of each lease year. Wren paid $15,000 to a real estate broker as a finder's fee. The building is depreciated $12,000 per year. For 1989, Wren incurred insurance and property tax expense totaling $9,000. Wren's net rental income for 1989 should be

a. $27,500  
b. $29,000  
c. $35,000  
d. $36,500

1N90#38. On November 15, 1989, Celt, Inc., a U.S. company, ordered merchandise FOB shipping point from an East German company for 200,000 marks. The merchandise was shipped and invoiced to Celt on December 10, 1989. Celt paid the invoice on January 10, 1990. The spot rates for marks on the respective dates are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 15, 1989</td>
<td>.4955</td>
</tr>
<tr>
<td>December 10, 1989</td>
<td>.4875</td>
</tr>
<tr>
<td>December 31, 1989</td>
<td>.4675</td>
</tr>
<tr>
<td>January 10, 1990</td>
<td>.4475</td>
</tr>
</tbody>
</table>

In Celt's December 31, 1989 income statement, the foreign exchange gain is

a. $9,600  
b. $8,000  
c. $4,000  
d. $1,600

1N90#39. Adam Corp. had the following infrequent transactions during 1989:

• A $190,000 gain on reacquisition and retirement of bonds.

• A $260,000 gain on the disposal of a segment of a business. Adam continues similar operations at another location.

• A $90,000 loss on the abandonment of equipment. In its 1989 income statement, what amount should Adam report as total infrequent net gains that are not considered extraordinary?

a. $100,000  
b. $170,000  
c. $360,000  
d. $450,000
2N90#6. Amar Farms produced 300,000 pounds of cotton during the 1989 season. Amar sells all of its cotton to Brye Co., which has agreed to purchase Amar's entire production at the prevailing market price. Recent legislation assures that the market price will not fall below $0.70 per pound during the next two years. Amar’s costs of selling and distributing the cotton are immaterial and can be reasonably estimated. Amar reports its inventory at expected exit value. During 1989, Amar sold and delivered to Brye 200,000 pounds at the market price of $0.70. Amar sold the remaining 100,000 pounds during 1990 at the market price of $0.72. What amount of revenue should Amar recognize in 1989?
   a. $140,000
   b. $144,000
   c. $210,000
   d. $216,000

2N90#15. Gow Constructors, Inc. has consistently used the percentage-of-completion method of recognizing income. In 1989, Gow started work on an $18,000,000 construction contract that was completed in 1990. The following information was taken from Gow’s 1989 accounting records:

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/88</th>
<th>12/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>Progress billings</td>
<td>$6,600,000</td>
<td></td>
</tr>
<tr>
<td>Costs incurred</td>
<td>5,400,000</td>
<td></td>
</tr>
<tr>
<td>Collections</td>
<td>4,200,000</td>
<td></td>
</tr>
<tr>
<td>Estimated costs to complete</td>
<td>10,800,000</td>
<td></td>
</tr>
</tbody>
</table>

What amount of gross profit should Gow have recognized in 1989 on this contract?
   a. $1,400,000
   b. $1,200,000
   c. $900,000
   d. $600,000

2N90#20. During 1989, property owned by Arp Co. was acquired by the city in connection with a condemnation proceeding, resulting in a payment of $100,000 to Arp. The property's carrying amount was $70,000. Arp paid $45,000 in 1989 for replacement property. In Arp's income statement for the year ended December 31, 1989, what amount of gain should be reported on this involuntary conversion, disregarding income tax considerations?
   a. $0
   b. $15,000
   c. $25,000
   d. $50,000

1M90#43. Adam Co. reported sales revenue of $2,300,000 in its income statement for the year ended December 31, 1989. Additional information was as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>12/31/88</th>
<th>12/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$500,000</td>
<td>$650,000</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>(30,000)</td>
<td>(55,000)</td>
</tr>
</tbody>
</table>

Uncollectible accounts totaling $10,000 were written off during 1989. Under the cash basis of accounting, Adam would have reported 1989 sales of
   a. $2,140,000
   b. $2,150,000
   c. $2,175,000
   d. $2,450,000

1M90#44. On October 20, 1989, Grimm Co. consigned 40 freezers to Holden Co. for sale at $1,000 each and paid $800 in transportation costs. On December 30, 1989, Holden reported the sale of 10 freezers and remitted $8,500. The remittance was net of the agreed 15% commission. What amount should Grimm recognize as consignment sales revenue for 1989?
   a. $7,700
   b. $8,500
   c. $9,800
   d. $10,000

1M90#45. On December 31, 1988, Mill Co. sold construction equipment to Drew, Inc. for $1,800,000. The equipment had a carrying amount of $1,200,000. Drew paid $300,000 cash on December 31, 1988 and signed a $1,500,000 note bearing interest at 10%, payable in five annual installments of $300,000. Mill appropriately accounts for the sale under the installment method. On December 31, 1989, Drew paid $300,000 principal and $150,000 interest. For the year ended December 31,
1989, what total amount of revenue should Mill recognize from the construction equipment sale and financing?

a. $250,000
b. $150,000
c. $120,000
d. $100,000

1M90#46. On July 1, 1989, Pell Co. purchased Green Corp. ten-year, 8% bonds with a face amount of $500,000 for $420,000. The bonds mature on June 30, 1997 and pay interest semiannually on June 30 and December 31. Using the interest method, Pell recorded bond discount amortization of $1,800 for the six months ended December 31, 1989. From this long-term investment, Pell should report 1989 revenue of

a. $16,800
b. $18,200
c. $20,000
d. $21,800

1M90#47. Simpson Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:

- A cash dividend of $8,000 from Wren Corp., in which Simpson owns a 2% interest.
- A cash dividend of $45,000 from Brill Corp., in which Simpson owns a 30% interest. This investment is appropriately accounted for using the equity method.
- A stock dividend of 500 shares from Paul Corp. was received on December 15, 1989, when the quoted market value of Paul’s shares was $10 per share. Simpson owns less than 1% of Paul’s common stock.

In Simpson’s 1989 income statement, dividend revenue should be

a. $58,000
b. $53,000
c. $13,000
d. $8,000

1M90#48. Rapp Co. leased a new machine to Lake Co. on January 1, 1989. The lease expires on January 1, 1994. The annual rental is $90,000. Additionally, on January 1, 1989, Lake paid $50,000 to Rapp as a lease bonus and $25,000 as a security deposit to be refunded upon expiration of the lease. In Rapp’s 1989 income statement, the amount of rental revenue should be

a. $140,000
b. $125,000
c. $100,000
d. $90,000

1M90#41. During 1988, Mitchell Corp. started a construction job with a total contract price of $600,000. The job was completed on December 15, 1989. Additional data are as follows:

<table>
<thead>
<tr>
<th>Actual costs incurred</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$225,000</td>
<td>$255,000</td>
</tr>
<tr>
<td>Estimated remaining costs</td>
<td>225,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Billed to customer</td>
<td>240,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Received from customer</td>
<td>200,000</td>
<td>400,000</td>
</tr>
</tbody>
</table>

Under the completed contract method, what amount should Mitchell recognize as gross profit for 1989?

a. $45,000
b. $72,000
c. $80,000
d. $120,000

2M90#44. Certain balance sheet accounts of a foreign subsidiary of Rowan, Inc., at December 31, 1989, have been translated into U.S. dollars as follows:

<table>
<thead>
<tr>
<th>Translated at</th>
<th>Current rates</th>
<th>Historical rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note receivable, long-term</td>
<td>$240,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>85,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Patent</td>
<td>150,000</td>
<td>170,000</td>
</tr>
<tr>
<td></td>
<td><strong>$475,000</strong></td>
<td><strong>$450,000</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 Rowan’s December 31, 1989 consolidated balance sheet for the above accounts?

a. $450,000
b. $455,000
c. $475,000
d. $495,000

2M90#45. Bolte Corp. had the following infrequent gains during 1989:

- $210,000 on reacquisition and retirement of bonds.
- $75,000 on repayment at maturity of a long-term note denominated in a foreign currency.
- $240,000 on sale of a plant facility (Bolte continues similar operations at another location.)

In its 1989 income statement, what amount should Bolte report as total infrequent gains which are not considered extraordinary?

a. $450,000
b. $315,000
c. $285,000
d. $240,000

2M90#47. Mill Construction Co. uses the percentage-of-completion method of accounting. During 1989, Mill contracted to build an apartment complex for Drew for $20,000,000. Mill estimated that total costs would amount to $16,000,000 over the period of construction.
In connection with this contract, Mill incurred $2,000,000 of construction costs during 1989. Mill billed and collected $3,000,000 from Drew in 1989. What amount should Mill recognize as gross profit for 1989?

a. $250,000  
b. $375,000  
c. $500,000  
d. $600,000

1N89#34. Peg Co. leased equipment from Howe Corp. on July 1, 1988 for an eight-year period expiring June 30, 1996. Equal payments under the lease are $600,000 and are due on July 1 of each year. The first payment was made on July 1, 1988. The rate of interest contemplated by Peg and Howe is 10%. The cash selling price of the equipment is $3,520,000, and the cost of the equipment on Howe’s accounting records is $2,800,000. The lease is appropriately recorded as a sales-type lease. What is the amount of profit on the sale and interest revenue that Howe should record for the year ended December 31, 1988?

<table>
<thead>
<tr>
<th>Profit on sale</th>
<th>Interest revenue</th>
</tr>
</thead>
</table>
a. $720,000     | $176,000         |
b. $720,000     | $146,000         |
c. $45,000      | $176,000         |
d. $45,000      | $146,000         |

1N89#35. On October 1, 1988, Price Corp., a real estate developer, sold land to Greene Co. for $5,000,000. Greene paid $600,000 cash and signed a 10-year $4,400,000 note bearing interest at 12%. The carrying amount of the land was $4,000,000 on date of sale. The note was payable in forty quarterly principal installments of $110,000 beginning January 2, 1989. Price appropriately accounts for the sale under the cost recovery method. On January 2, 1989, Greene paid the first principal installment of $110,000 and interest of $132,000. For the year ended December 31, 1988, what total amount of income should Price recognize from the land sale and financing?

a. $0  
b. $120,000  
c. $132,000  
d. $252,000

1N89#36. John Tracey, M.D., keeps his accounting records on the cash basis. During 1988, Dr. Tracey collected $150,000 in fees from his patients. At December 31, 1987, Dr. Tracey had accounts receivable of $20,000. At December 31, 1988, Dr. Tracey had accounts receivable of $35,000 and unearned fees of $5,000. On the accrual basis, how much was Dr. Tracey’s patient service revenue for 1988?

a. $130,000  
b. $160,000  
c. $165,000  
d. $170,000

1N89#37. On January 1, 1988, Dyer Co. acquired as a long-term investment a 20% common stock interest in Eason Co. Dyer paid $700,000 for this investment when the fair value of Eason’s net assets was $3,500,000. Dyer can exercise significant influence over Eason’s operating and financial policies. For the year ended December 31, 1988, Eason reported net income of $400,000 and declared and paid cash dividends of $160,000. How much revenue from this investment should Dyer report for 1988?

a. $32,000  
b. $48,000  
c. $80,000  
d. $112,000

1N89#38. On January 1, 1988, Jaffe Co. leased a machine to Pender Co. for ten years, with $10,000 payments due at the beginning of each year effective at the inception of the lease. The machine cost Jaffe $55,000. The lease is appropriately accounted for as a sales-type lease by Jaffe. The present value of the ten rent payments over the lease term discounted appropriately at 10% was $67,600. The estimated salvage value of the machine at the end of ten years is equal to the disposal costs. How much interest revenue should Jaffe record from the lease for the year ended December 31, 1988?

a. $5,500  
b. $5,760  
c. $6,760  
d. $7,020

1N89#39. Albert Co. acquired 4,000 shares of Nolan, Inc. common stock on October 20, 1986 for $66,000. On November 30, 1988, Nolan distributed a 10% common stock dividend when the market price of the stock was $25 per share. On December 20, 1988, Albert sold 400 shares of its Nolan stock for $10,600. For the year ended December 31, 1988, how much should Albert report as dividend revenue?

a. $10,600  
b. $10,000  
c. $4,600  
d. $0

1N89#40. On January 2, 1988, Osborn Co. assigned its patent to Aile for royalties of 10% of patent related sales. On the same date, Osborn received a $40,000 advance to be applied against royalties for 1988 sales. Royalties are payable every six months. Aile reported the following sales:

<table>
<thead>
<tr>
<th>Six months ended</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 1988</td>
<td>$150,000</td>
</tr>
<tr>
<td>December 31, 1988</td>
<td>200,000</td>
</tr>
</tbody>
</table>

How much royalty revenue should Osborn report in its 1988 income statement?

a. $75,000  
b. $60,000  
c. $40,000  
d. $35,000
Selected Questions

1M89#41. On January 3, 1986, Falk Co. purchased 500 shares of Milo Corp. common stock for $36,000. On December 2, 1988, Falk received 500 stock rights from Milo. Each right entitles the holder to acquire one share of stock for $85. The market price of Milo's stock was $100 a share immediately before the rights were issued, and $90 a share immediately after the rights were issued. Falk sold its rights on December 3, 1988 for $10 a right. Falk's gain from the sale of the rights is

a. $0
b. $1,000
c. $1,400
d. $5,000

1M89#43. On April 8, 1987, Day Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. Day paid the bill in full on March 1, 1988 when the spot rate was $.45. The spot rate was $.60 on April 8, 1987 and was $.55 on December 31, 1987. For the year ended December 31, 1988, Day should report a transaction gain of

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

1M89#44. On January 2, 1987, Troast Co. purchased as a long-term investment 10,000 shares of Lawton Corp. common stock for $70 per share, which represents a 1% interest. On December 31, 1987, the market price of the stock was $75 per share. On December 20, 1988, Troast needed additional cash for operations and sold all 10,000 shares of Lawton's stock for $100 per share. Troast's income tax rate was 30% for 1988. For the year ended December 31, 1988, Troast should report on its income statement a gain on disposal of

a. $300,000
b. $250,000
c. $210,000
d. $175,000

1M89#50. Greg Corp. reported revenue of $1,250,000 in its accrual basis income statement for the year ended June 30, 1989. Additional information was as follows:

Accounts receivable June 30, 1988 $400,000
Accounts receivable June 30, 1989 530,000
Uncollectible accounts written off during the fiscal year 15,000

Under the cash basis, Greg should report revenue of

a. $855,000
b. $850,000
c. $1,105,000
d. $1,135,000

1M89#51. On January 2, 1988, Rex Enterprises, Inc. authorized Adam Company to operate as a franchisee over a 20-year period for an initial franchise fee of $60,000 received on signing the agreement. Adam started operations on June 30, 1988, by which date Rex had performed all of the required initial services. In its income statement for the six months ended June 30, 1988, what amount should Rex report as revenue from franchise fees in connection with Adam's franchise?

a. $0
b. $1,500
c. $30,000
d. $60,000

1M89#53. Zach Company assigns some of its patents to other enterprises under a variety of licensing agreements. In some instances, advance royalties are received when the agreements are signed and, in others, royalties are remitted within 60 days after each license year end. The following data are included in Zach's December 31 balance sheets:

<table>
<thead>
<tr>
<th>Royalties receivable</th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$90,000</td>
<td>$85,000</td>
</tr>
<tr>
<td>Unearned royalties</td>
<td>60,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

During 1988, Zach received royalty remittances of $200,000. In its income statement for the year ended December 31, 1988, Zach should report royalty revenue of

a. $225,000
b. $215,000
c. $205,000
d. $195,000

1M89#54. On January 1, 1988, Post Corp. leased a warehouse to Winn under an operating lease for ten years at $60,000 per year, payable the first day of each lease year. Post paid $27,000 to a real estate broker as a finder's fee. The warehouse is depreciated $15,000 per year. For 1988, Post incurred insurance and property tax expense totaling $12,000. Post's net rental income for 1988 should be

a. $33,000
b. $30,300
c. $21,000
d. $6,000

1877 | 1988 |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.  $500</td>
<td>($1,000)</td>
</tr>
<tr>
<td>b.  $0</td>
<td>($500)</td>
</tr>
<tr>
<td>c. ($500)</td>
<td>0</td>
</tr>
<tr>
<td>d. ($1,000)</td>
<td>$500</td>
</tr>
</tbody>
</table>

AP-61
Accounting Practice

1N88#59. On January 1, 1987, Tone Company exchanged equipment for a $200,000 noninterest bearing note due on January 1, 1990. The prevailing rate of interest for a note of this type at January 1, 1987 was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Tone's 1988 income statement?

- a. $ 7,500
- b. $15,000
- c. $16,500
- d. $20,000

1N88#31. On October 1, 1987, Yost Corp. acquired for cash all of the voting common stock of Leer, Inc. The purchase price of Leer's stock equaled the book value and fair value of Leer's net assets. The separate net income for each company, excluding Yost's share of income from Leer, was as follows:

<table>
<thead>
<tr>
<th></th>
<th>Yost</th>
<th>Leer</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/87</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

1N88#33. In its accrual basis income statement for the year ended December 31, 1987, Glen Corp. reported revenue of $1,550,000. Additional information was as follows:

Accounts receivable — December 31, 1986: $350,000
Accounts receivable — December 31, 1987: $550,000

Under the cash basis, how much should Glen report as revenue for 1987?

- a. $1,000,000
- b. $1,200,000
- c. $1,350,000
- d. $1,750,000

1N88#34. Lewis Company's usual sales terms are net 60 days, F.O.B. shipping point. Sales, net of returns and allowances, totaled $2,300,000 for the year ended December 31, 1987, before year-end adjustments. Additional data are as follows:

- On December 27, 1987, Lewis authorized a customer to return, for full credit, goods shipped and billed at $50,000 on December 15, 1987. The returned goods were received by Lewis on January 4, 1988, and a $50,000 credit memo was issued and recorded on the same date.
- Goods with an invoice amount of $80,000 were billed and recorded on January 3, 1988. The goods were shipped on December 30, 1987.
- Goods with an invoice amount of $100,000 were billed and recorded on December 30, 1987. The goods were shipped on January 3, 1988.

Lewis' adjusted net sales for 1987 should be

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

1N88#35. Hill Company began operations on January 1, 1987, and appropriately uses the installment method of accounting. Data available for 1987 are as follows:

| Installment accounts receivable, 12/31/87 | $500,000 |
| Installment sales                      | 900,000  |
| Cost of goods sold, as percentage of sales | 60% |

Using the installment method, Hill's realized gross profit for 1987 would be

- a. $360,000
- b. $240,000
- c. $200,000
- d. $160,000

1N88#36. On January 1, 1986, Mill Company sold a building and received as consideration $100,000 cash and a $400,000 noninterest bearing note due on January 1, 1989. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1987 income statement?

- a. $44,000
- b. $40,000
- c. $33,333
- d. $33,000

1N88#37. Dix Company acquired 2,000 shares of Lane, Inc. common stock on October 5, 1985, at a cost of $44,000. On April 10, 1987, Lane distributed a 10% common stock dividend when the market price of the stock was $30 per share. On December 20, 1987, Dix sold 200 shares of its Lane stock for $6,400. For the year ended December 31, 1987, what amount should Dix report as dividend revenue?

- a. $0
- b. $2,400
- c. $6,000
- d. $6,400

1N88#38. On January 1, 1988, Ott Company sold goods to Fox Company. Fox signed a noninterest-bearing note requiring payment of $60,000 annually for
Selected Questions

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:

<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>

Ott should record sales revenue in January 1988 of
a. $321,600
b. $292,200
c. $261,600
d. $214,200


a. $92,000
b. $142,000
c. $150,000
d. $192,000

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

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>Accounts receivable</td>
<td>$415,000</td>
<td>$550,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>25,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

No uncollectible accounts were written off during 1987.

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

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 as follows:

<table>
<thead>
<tr>
<th>At December 31,</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of completion</td>
<td>20%</td>
<td>60%</td>
</tr>
<tr>
<td>Estimated total cost at completion</td>
<td>$7,500,000</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>Income recognized (cumulative)</td>
<td>500,000</td>
<td>1,200,000</td>
</tr>
</tbody>
</table>

Contract costs incurred during 1986 were

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

Ball Corporation had the following infrequent gains during 1986:

- A $240,000 gain on sale of a plant facility; Ball continues similar operations at another location.
- A $90,000 gain on repayment of a long-term note denominated in a foreign currency.
- A $190,000 gain on reacquisition and retirement of bonds.

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

a. $520,000
b. $430,000
c. $330,000
d. $280,000

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 dis-
count 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?

1N87#36. Clay Company assigns patent rights, for which advance royalties are received in some cases and, in others, royalties are remitted within 60 days after each license year end. The following data are available from Clay's accounting records:

At December 31,

<table>
<thead>
<tr>
<th>Royalties receivable</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$75,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Unearned royalties</td>
<td>45,000</td>
<td>65,000</td>
</tr>
</tbody>
</table>

During 1986 Clay received royalty remittances of $250,000. In its 1986 income statement, Clay should report royalty revenue of
a. $225,000
b. $230,000
c. $235,000
d. $255,000

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?

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</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#36. 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

1N87#36. Certain balance sheet accounts of a foreign subsidiary of Post, Inc., at December 31, 1986, have been translated into U.S. dollars as follows:

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

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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total contract price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Actual costs during 1986</td>
<td>20,000</td>
</tr>
<tr>
<td>Estimated remaining costs</td>
<td>40,000</td>
</tr>
<tr>
<td>Billed to customer during 1986</td>
<td>30,000</td>
</tr>
<tr>
<td>Received from customer during 1986</td>
<td>10,000</td>
</tr>
</tbody>
</table>

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 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock:</td>
<td></td>
</tr>
<tr>
<td>Kar Corp. (1,000 shares)</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Aub Corp. (5,000 shares)</td>
<td>100,000</td>
</tr>
<tr>
<td>Real estate:</td>
<td></td>
</tr>
<tr>
<td>Parking lot (leased to Day Co.)</td>
<td>300,000</td>
</tr>
<tr>
<td>Other:</td>
<td></td>
</tr>
<tr>
<td>Trademark (at cost, less accumulated amortization)</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Total investments $435,000

Lake owns 1% of Kar and 30% of Aub. Lake's directors constitute a majority of Aub's directors. The Day lease, which commenced on January 1, 1984, is for ten years, at an annual rental of $48,000. In addition, on January 1, 1984, Day paid a nonrefundable deposit of $50,000,
Accounting Practice

as well as a security deposit of $8,000 to be refunded upon expiration of the lease. The trademark was licensed to Barr Co. for royalties of 10% of sales of the trademarked items. Royalties are payable semiannually on March 1 (for sales in July through December of the prior year), and on September 1 (for sales in January through June of the same year).

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

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

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

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

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

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

2M67#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

B. Expenses and Losses

1M91#51. In connection with a stock option plan for the benefit of key employees, Ward Corp. intends to distribute treasury shares when the options are exercised. These shares were bought in 1989 at $42 per share. On January 1, 1990, Ward granted stock options for 10,000 shares at $38 per share as additional compensation for services to be rendered over the next three years. The options are exercisable during a 4-year period beginning January 1, 1992, by grantees still employed by Ward. Market price of Ward's stock was $47 per share at the grant date. No stock options were terminated during 1990. In Ward's December 31, 1990, income statement, what amount should be reported as compensation expense pertaining to the options?
   - a. $90,000
   - b. $40,000
   - c. $30,000
   - d. $0

1M91#54. At December 31, 1990, Ashe Co. had a $990,000 balance in its advertising expense account before any year-end adjustments relating to the following:

- Radio advertising spots broadcast during December 1990 were billed to Ashe on January 4, 1991. The invoice cost of $50,000 was paid on January 15, 1991.
- Included in the $990,000 is $60,000 for newspaper advertising for a January 1991 sales promotional campaign.

Ashe's advertising expense for the year ended December 31, 1990, should be
   - a. $930,000
   - b. $980,000
   - c. $1,000,000
   - d. $1,040,000

1M91#55. On July 1, 1990, Day Co. received $103,288 for $100,000 face amount, 12% bonds, a price that yields 10%. Interest expense for the six months ended December 31, 1990, should be
   - a. $6,197
   - b. $6,000
   - c. $5,164
   - d. $5,000

1M91#56. Based on 1990 sales of compact discs recorded by an artist under a contract with Bain Co., the artist earned $100,000 after an adjustment of $8,000 for anticipated returns. In addition, Bain paid the artist $75,000 in 1990 as a reasonable estimate of the amount recoverable from future royalties to be earned by the artist. What amount should Bain report in its 1990 income statement for royalty expense?
   - a. $100,000
   - b. $108,000
   - c. $175,000
   - d. $183,000

AP-66
Selected Questions

1N90#57. On December 1, 1990, Tell Co. leased office space for five years at a monthly rental of $60,000. On the same date, Tell paid the lessor the following amounts:

- First month's rent $60,000
- Last month's rent 60,000
- Security deposit (refundable at lease expiration) 80,000
- Installation of new walls and offices 360,000

Tell's 1990 expense relating to utilization of the office space should be

a. $140,000
b. $120,000
c. $66,000
d. $60,000

1N90#58. On January 2, 1989, Adam Co. purchased as a long-term investment 10,000 shares of Mill Corp.'s common stock for $40 a share. On December 31, 1989, the market price of Mill's stock was $35 a share, reflecting a temporary decline in market price. On December 28, 1990, Adam sold 8,000 shares of Mill stock for $30 a share. For the year ended December 31, 1990, Adam should report a loss on disposal of long-term investment of

a. $100,000
b. $90,000
c. $80,000
d. $40,000

1N90#40. Brock Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 1989 included the following expense and loss accounts:

- Accounting and legal fees $120,000
- Advertising 150,000
- Freight out 80,000
- Interest 70,000
- Loss on sale of long-term investment 30,000
- Officers' salaries 225,000
- Rent for office space 220,000
- Sales salaries and commissions 140,000

One-half of the rented premises is occupied by the sales department.

Brock's total selling expenses for 1989 are

a. $480,000
b. $400,000
c. $370,000
d. $360,000

1N90#41. On January 1, 1990, Korn Co. sold to Kay Corp. $400,000 of its 10% bonds for $354,118 to yield 12%. Interest is payable semiannually on January 1 and July 1. What amount should Korn report as interest expense for the six months ended June 30, 1990?

a. $17,706
b. $20,000
c. $21,247
d. $24,000

1N90#42. Cody Corp. incurred the following costs during 1989:

Design of tools, jigs, molds, and dies involving new technology $125,000
Modification of the formulation of a process 160,000
Trouble-shooting in connection with breakdowns during commercial production 100,000
Adaptation of an existing capability to a particular customer's need as part of a continuing commercial activity 110,000

In its 1989 income statement, Cody should report research and development expense of

a. $125,000
b. $160,000
c. $235,000
d. $285,000

1N90#43. Ball Corp. had the following foreign currency transactions during 1989:

- Merchandise was purchased from a foreign supplier on January 20, 1989 for the U.S. dollar equivalent of $90,000. The invoice was paid on March 20, 1989 at the U.S. dollar equivalent of $96,000.
- On July 1, 1989, Ball borrowed the U.S. dollar equivalent of $500,000 evidenced by a note that was payable in the lender's local currency on July 1, 1991. On December 31, 1989, the U.S. dollar equivalents of the principal amount and accrued interest were $520,000 and $26,000, respectively. Interest on the note is 10% per annum.

In Ball's 1989 income statement, what amount should be included as foreign exchange loss?

a. $0
b. $6,000
c. $21,000
d. $27,000

1N90#44. On January 1, 1989, Pall Corp. granted stock options to key employees for the purchase of 40,000 shares of the company's common stock at $25 per share. The options are intended to compensate employees for the next two years. The options are exercisable within a four-year period beginning January 1, 1991 by grantees still in the employ of the company. The market price of Pall's common stock was $33 per share at the date of grant. No stock options were terminated during the year. What amount should Pall charge to compensation expense for the year ended December 31, 1989?

a. $320,000
b. $160,000
c. $80,000
d. $0

AP-67
Accounting Practice

1N90#45. Orr Co. prepared an aging of its accounts receivable at December 31, 1989 and determined that the net realizable value of the receivables was $250,000. Additional information is available as follows:

- Allowance for uncollectible accounts at 1/1/89 — credit balance: $28,000
- Accounts written off as uncollectible during 1989: 23,000
- Accounts receivable at 12/31/89: 270,000
- Uncollectible accounts recovery during 1989: 5,000

For the year ended December 31, 1989, Orr’s uncollectible accounts expense would be:

a. $23,000
b. $20,000
c. $15,000
d. $10,000

1N90#46. Kew Apparel, Inc. leases and operates a retail store. The following information relates to the lease for the year ended December 31, 1989:

- The store lease, an operating lease, calls for a base monthly rent of $1,500 on the first day of each month.
- Additional rent is computed at 6% of net sales over $300,000 up to $600,000 and 5% of net sales over $600,000, per calendar year.
- Net sales for 1989 were $900,000.
- Kew paid executory costs to the lessor for property taxes of $12,000 and insurance of $5,000.

For 1989, Kew’s expenses relating to the store lease are:

a. $71,000
b. $68,000
c. $54,000
d. $35,000

1N90#47. Strand, Inc. incurred the following infrequent losses during 1989:

- A $90,000 write-down of equipment leased to others.
- $50,000 adjustment of accruals on long-term contracts.
- A $75,000 write-off of obsolete inventory.

In its 1989 income statement, what amount should Strand report as total infrequent losses that are not considered extraordinary?

a. $215,000
b. $165,000
c. $140,000
d. $125,000

2N90#8. The following information was derived from the 1989 accounting records of Clem Co.:

<table>
<thead>
<tr>
<th></th>
<th>Clem’s central warehouse</th>
<th>Clem’s goods held by consignees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>$110,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>480,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Freight in</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Transportation to consignees</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Freight out</td>
<td>30,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>145,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Clem’s 1989 cost of sales was:

a. $455,000
b. $485,000
c. $507,000
d. $512,000

2N90#10. The following items were among those that were reported on Lee Co.’s income statement for the year ended December 31, 1989:

- Legal and audit fees: $170,000
- Rent for office space: 240,000
- Interest on inventory floorplan: 210,000
- Loss on abandoned data processing equipment used in operations: 35,000

The office space is used equally by Lee’s sales and accounting departments. What amount of the above-listed items should be classified as general and administrative expenses in Lee’s multiple-step income statement?

a. $290,000
b. $325,000
c. $410,000
d. $500,000

2N90#11. On its December 31, 1988 balance sheet, Nilo Corp. reported bonds payable of $8,000,000 and related unamortized bond issue costs of $430,000. The bonds had been issued at par. On January 2, 1989, Nilo retired $4,000,000 of the outstanding bonds at par plus a call premium of $100,000. What amount should Nilo report in its 1989 income statement as loss on extinguishment of debt?

a. $0
b. $100,000
c. $215,000
d. $315,000

2N90#12. Zahn Corp.’s comparative balance sheet at December 31, 1989 and 1988 reported accumulated depreciation balances of $800,000 and $600,000 respectively. Property with a cost of $50,000 and a carrying amount of $40,000 was the only property sold in 1989. Depreciation charged to operations in 1989 was:

a. $190,000
b. $200,000
c. $210,000
d. $220,000

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1M90#49. The following information was taken from Cody Co.'s accounting records for the year ended December 31, 1989:

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

There was no work-in-process inventory at the beginning or end of the year. Cody's 1989 cost of goods sold is:

a. $895,000
b. $910,000
c. $950,000
d. $955,000

1M90
Items 50 and 51 are based on the following:

On January 2, 1989, Dix Machine Shops, Inc. signed a ten-year noncancellable lease for a heavy duty drill press. The lease stipulated annual payments of $30,000 starting at the end of the first year, with title passing to Dix at the expiration of the lease. Dix treated this transaction as a capital lease. The drill press has an estimated useful life of 15 years, with no salvage value. Dix uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of $180,000, based on implicit interest of 10%.

50. In its 1989 income statement, what amount of interest expense should Dix report from this lease transaction?
   a. $0
   b. $12,000
   c. $15,000
   d. $18,000

51. In its 1989 income statement, what amount of depreciation expense should Dix report from this lease transaction?
   a. $30,000
   b. $20,000
   c. $18,000
   d. $12,000

1M90#52. Fay Corp. had a realized foreign exchange loss of $15,000 for the year ended December 31, 1989 and must also determine whether the following items will require year-end adjustment:

- Fay had an $8,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1989.
- Fay had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was $64,000 on the October 31, 1989 invoice date, and it was $60,000 on December 31, 1989. The invoice is payable on January 30, 1990.

In Fay's 1989 consolidated income statement, what amount should be included as foreign exchange loss?
   a. $11,000
   b. $15,000
   c. $19,000
   d. $23,000

1M90#53. During 1989, Vest Co. incurred the following costs:

- Testing in search for process alternatives: $280,000
- Routine design of tools, jigs, molds and dies: $250,000
- Modification of the formulation of a process: $410,000
- Research and development services performed by Acme Corp. for Vest: $325,000

In Vest's 1989 income statement, research and development expense should be:
   a. $410,000
   b. $725,000
   c. $1,015,000
   d. $1,265,000

1M90#54. For the year ended December 31, 1989, Beal Co. estimated its allowance for uncollectible accounts using the year-end aging of accounts receivable. The following data are available:

- Allowance for uncollectible accounts, 1/1/89: $42,000
- Provision for uncollectible accounts during 1989 (2% on credit sales of $2,000,000): $40,000
- Uncollectible accounts written off, 11/30/89: $46,000
- Estimated uncollectible accounts per aging, 12/31/89: $52,000

After year-end adjustment, the uncollectible accounts expense for 1989 should be:
   a. $46,000
   b. $48,000
   c. $52,000
   d. $56,000

1M90#55. On January 2, 1989, Morey Corp. granted Dean, its president, 20,000 stock appreciation rights for past services. Those rights are exercisable immediately and expire on January 1, 1992. On exercise, Dean is entitled to receive cash for the excess of the stock's market price on the exercise date over the market price on the grant date. Dean did not exercise any of the rights during 1989. The market price of Morey's stock was $30 on January 2, 1989 and $43 on December 31, 1989. As a result of the stock appreciation rights, Morey should recognize compensation expense for 1989 of
   a. $0
   b. $100,000
   c. $300,000
   d. $600,000
Accounting Practice

1M90#56. On January 1, 1989, Park Co. signed a 10-year operating lease for office space at $96,000 per year. The lease included a provision for additional rent of 5% of annual company sales in excess of $500,000. Park’s sales for the year ended December 31, 1989 were $600,000. Upon execution of the lease, Park paid $24,000 as a bonus for the lease. Park’s rent expense for the year ended December 31, 1989 is
   a. $98,400
   b. $101,000
   c. $103,400
   d. $125,000

1M90#57. During 1988, Wall Co. purchased 2,000 shares of Hemp Corp. common stock for $31,500 as a short-term investment. The market value of this investment was $29,500 at December 31, 1988. Wall sold all of the Hemp common stock for $14 per share on December 15, 1989, incurring $1,400 in brokerage commissions and taxes. On the sale, Wall should report a realized loss of
   a. $4,900
   b. $3,500
   c. $2,900
   d. $1,500

1M90#58. Witt Co. incurred the following infrequent losses during 1989:
   • $175,000 from a major strike by employees.
   • $150,000 from an early extinguishment of debt.
   • $125,000 from the abandonment of equipment used in the business.

In Witt’s 1989 income statement, the total amount of infrequent losses not considered extraordinary should be
   a. $275,000
   b. $300,000
   c. $325,000
   d. $450,000

2M90#46. Doren Co.’s officers’ compensation expense account had a balance of $490,000 at December 31, 1989 before any appropriate year-end adjustment relating to the following:
   • No salary accrual was made for the week of December 25–31, 1989. Officers’ salaries for this period totaled $18,000 and were paid on January 5, 1990.
   • Bonuses to officers for 1989 were paid on January 31, 1990 in the total amount of $175,000.

The adjusted balance for officers’ compensation expense for the year ended December 31, 1989 should be
   a. $683,000
   b. $665,000
   c. $508,000
   d. $490,000

2M90#48. Casey Co.’s adjusted trial balance at December 31, 1989 included the following expense accounts:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>$250,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>75,000</td>
</tr>
<tr>
<td>Rent for office space</td>
<td>180,000</td>
</tr>
<tr>
<td>Sales salaries and commissions</td>
<td>200,000</td>
</tr>
</tbody>
</table>

One-half of the office space is occupied by the sales department.

What total amount of the expenses listed above should be included in Casey’s selling and delivery expenses for 1989?
   a. $450,000
   b. $525,000
   c. $540,000
   d. $615,000

2M90#49. On January 1, 1988, Layton Co. acquired the copyright to a book owned by Garner for royalties of 15% of future book sales. Royalties are payable on September 30 for sales in January through June of the same year, and on March 31 for sales in July through December of the preceding year. During 1988 and 1989, Layton remitted royalty checks to Garner as follows:

| Month          | Royalty
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31</td>
<td>$</td>
</tr>
<tr>
<td>September 30</td>
<td>$25,000</td>
</tr>
<tr>
<td>1988</td>
<td>$200,000</td>
</tr>
<tr>
<td>1988</td>
<td>22,000</td>
</tr>
<tr>
<td>1989</td>
<td>20,000</td>
</tr>
<tr>
<td>1989</td>
<td>40,000</td>
</tr>
</tbody>
</table>

Layton’s sales of the Garner book totaled $300,000 for the last half of 1989. In its 1989 income statement, Layton should report royalty expense of
   a. $85,000
   b. $67,000
   c. $62,000
   d. $45,000

1N89#42. On December 1, 1988, Barr Company leased office space for five years at a monthly rental of
$60,000. On that date, Barr paid the lessor the following amounts:

- First month's rent: $60,000
- Last month's rent: 60,000
- Security deposit (refundable at lease expiration): 80,000
- Installation of new walls and offices: 360,000

Barr's December 1988 expense relating to its use of this office space is:

- a. $60,000
- b. $66,000
- c. $126,000
- d. $200,000

1M89#11. The following data were available from Mith Co.'s records on December 31, 1988:

- Finished goods inventory, 1/1/88: $120,000
- Finished goods inventory, 12/31/88: 110,000
- Cost of goods manufactured: 520,000
- Loss on sale of plant equipment: 50,000

The cost of goods sold for 1988 was:

- a. $510,000
- b. $520,000
- c. $530,000
- d. $580,000

1M89#12. As an inducement to enter a lease, Arts, Inc., a lessor, grants Homer Corp., a lessee, nine months of free rent under a five-year operating lease. The lease is effective on July 1, 1988 and provides for monthly rental of $1,000 to begin April 1, 1989.

In Homer's income statement for the year ended June 30, 1989, rent expense should be reported as:

- a. $10,200
- b. $9,000
- c. $3,000
- d. $2,550

1M89#19. During 1988, Rine Company incurred the following costs:

- Research and development services performed by Lee Corp. for Rine: $300,000
- Testing for evaluation of new products: 250,000
- Laboratory research aimed at discovery of new knowledge: 370,000
- Routine design of tools, jigs, molds, and dies: 100,000

In its income statement for the year ended December 31, 1988, Rine should report research and development expense of:

- a. $1,020,000
- b. $920,000
- c. $720,000
- d. $670,000

1M89#20. The balance in Bart Corp.'s foreign exchange loss account was $13,000 at December 31, 1988, before any necessary year-end adjustment relating to the following:

- Bart had a $20,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1988.
- Bart had an account payable to an unrelated foreign supplier payable in the local currency of the foreign supplier on January 27, 1989. The U.S. dollar equivalent of the payable was $100,000 on the November 28, 1988 invoice date, and it was $106,000 on December 31, 1988.

In Bart's 1988 consolidated income statement, what amount should be included as foreign exchange loss?

- a. $33,000
- b. $27,000
- c. $19,000
- d. $13,000

1M89#48. Cain Co. issued $400,000 face amount of its 10% bonds on January 1, 1989 for $354,118 to yield the buyer a 12% effective rate of return. Interest is payable semiannually on January 1 and July 1. What amount would Cain report as interest expense in its June 30, 1989 income statement?

- a. $18,753
- b. $20,000
- c. $21,247
- d. $24,000

1M88#13. The following information is available for Mason Corp. for 1987:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>36,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>19,000</td>
</tr>
<tr>
<td>Freight out</td>
<td>9,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>43,000</td>
</tr>
</tbody>
</table>

Mason's cost of goods sold for 1987 is:

- a. $52,000
- b. $60,000
- c. $69,000
- d. $88,000

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

| Purchases | $530,000 |
| Purchase discounts | 10,000 |
| Beginning inventory | 160,000 |
| Ending inventory | 215,000 |
| Freight-out | 40,000 |

Dell's 1987 cost of goods sold is:

- a. $465,000
- b. $475,000
- c. $505,000
- d. $585,000
**Accounting Practice**

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

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$900,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts (before any provision for 1987 doubtful accounts expense)</td>
<td>$35,000</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 credit sales</th>
<th>Percentage of accounts receivable</th>
</tr>
</thead>
<tbody>
<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

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

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in raw materials inventory</td>
<td>$15,000</td>
</tr>
<tr>
<td>Decrease in finished goods inventory</td>
<td>$35,000</td>
</tr>
<tr>
<td>Raw materials purchased</td>
<td>$430,000</td>
</tr>
<tr>
<td>Direct-labor payroll</td>
<td>$200,000</td>
</tr>
<tr>
<td>Factory overhead</td>
<td>$300,000</td>
</tr>
<tr>
<td>Freight-out</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

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

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

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

- $51,000
- $51,000
- $150,000
- $29,000
- $45,000
- $35,000
- $29,000
- 185,000
- $135,000
- 35,000
- 430,000

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 accurses 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

1M87#47. On May 15, 1986, Hart, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1987, at a selling price of $1,000,000. Disposal costs incurred by Hart totaled $150,000, all of which were paid during 1986. The segment had actual or estimated operating losses as follows:

<table>
<thead>
<tr>
<th>Date Range</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/86 to 5/14/86</td>
<td>$130,000</td>
</tr>
<tr>
<td>5/15/86 to 12/31/86</td>
<td>$50,000</td>
</tr>
<tr>
<td>1/1/87 to 1/31/87</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

The carrying amount of the segment at the date of sale was expected to be $1,750,000. Ignore the income tax effects. What amount should Hart report as a loss on disposal of the segment in its 1986 income statement?

a. $0
b. $900,000
c. $915,000
d. $965,000

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disbursements for purchases</td>
<td>$150,000</td>
</tr>
<tr>
<td>Increase in trade accounts payable</td>
<td>$150,000</td>
</tr>
<tr>
<td>Decrease in merchandise inventory</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attorney's fees for incorporating</td>
<td>$6,000</td>
</tr>
<tr>
<td>State incorporation filing fees</td>
<td>4,000</td>
</tr>
</tbody>
</table>

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

Rex sold 1,000 shares of Company B stock on January 31, 1987, for $15 per share, incurring $1,500 in brokerage commission and taxes. On the sale, Rex should report a realized loss of
   a. $300
   b. $1,800
   c. $2,000
   d. $3,500

1M87#52. Jason Company incurred the following infrequent losses during 1986:
   - A major strike by employees shut down one of Jason’s factories. Shutdown losses totaled $180,000.
   - A loss of $100,000 from writedown of plant and equipment to estimated realizable value.
   - A loss of $150,000 on disposal of one of three similar factories.

In its 1986 income statement, how much should Jason report as total infrequent losses which are not considered extraordinary?
   a. $250,000
   b. $280,000
   c. $330,000
   d. $430,000

C. Provision for Income Tax

1N90#48. For calendar year 1989, Clark Corp. reported depreciation of $300,000 in its income statement. On its 1989 income tax return, Clark reported depreciation of $500,000. Clark’s income statement also included $50,000 accrued warranty expense that will be deducted for tax purposes when paid. Clark elected early application of FASB Statement No. 96, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1989. Clark’s enacted tax rates are 30% for 1989 and 1990, and 25% for 1991 and 1992. The depreciation difference and warranty expense will reverse over the next three years as follows:

<table>
<thead>
<tr>
<th>Depreciation difference</th>
<th>Warranty expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990 $80,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>1991 70,000</td>
<td>15,000</td>
</tr>
<tr>
<td>1992 50,000</td>
<td>25,000</td>
</tr>
<tr>
<td>$200,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

These were Clark’s only temporary differences. In Clark’s 1989 income statement, the deferred portion of its provision for income taxes should be
   a. $67,000
   b. $45,000
   c. $41,000
   d. $37,500

2N90#7. Ram Corp. prepared the following reconciliation of income per books with income per tax return for the year ended December 31, 1989:

Book income before income taxes $750,000
Add temporary difference
Construction contract revenue which will reverse in 1993 100,000
Deduct temporary difference
Depreciation expense which will reverse in equal amounts in each of the next four years (400,000)
Taxable income $450,000

Ram’s effective income tax rate is 34% for 1989. What amount should Ram report in its 1989 income statement as the current provision for income taxes?
   a. $34,000
   b. $153,000
   c. $255,000
   d. $289,000

1M90#39. For the year ended March 31, 1990, Dunn Corp.’s pretax financial statement income was $700,000, and its taxable income was $600,000. The difference is due to the following:

| Interest on municipal bonds | $30,000 |
| Lower depreciation for financial statement | $70,000 |
| **Total** | **$100,000** |

Dunn elected early application of FASB Statement No. 96, Accounting for Income Taxes. Dunn’s enacted
Selected Questions

income tax rate is 30%. What is Dunn's current portion of income tax expense for the year ended March 31, 1990?

a. $210,000  
b. $189,000  
c. $180,000  
d. $159,000

1N90#41. In 1989, Lobo Corp. reported for financial statement purposes the following revenue and expenses which were not included in taxable income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premiums on officers’ life insurance</td>
<td>under which the corporation is the beneficiary</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Interest revenue on qualified state or municipal bonds</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Estimated future warranty costs</td>
<td>to be paid in 1990 and 1991</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Lobo's enacted tax rate for the current and future years is 30%. Lobo has paid income taxes in the amount of $170,000 for the three-year period ended December 31, 1989. There were no temporary differences in prior years.

Lobo elected early application of FASB Statement No. 96, Accounting for Income Taxes. The deferred tax benefit to be applied against current income tax expense is

a. $18,000  
b. $19,500  
c. $21,000  
d. $22,500

1N89

Items 47 and 48 are based on the following:

Bee Corp. prepared the following reconciliation between book income and taxable income for the year ended December 31, 1988:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax accounting income</td>
<td>$500,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>300,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Differences:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on municipal bonds</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Lower depreciation per financial statements</td>
<td>150,000</td>
</tr>
<tr>
<td>Total differences</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Bee elected early application of FASB Statement No. 96, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1988.

Bee’s effective income tax rate for 1988 is 30%. The depreciation difference will reverse equally over the next three years at enacted tax rates as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>30%</td>
</tr>
<tr>
<td>1990</td>
<td>25%</td>
</tr>
<tr>
<td>1991</td>
<td>25%</td>
</tr>
</tbody>
</table>

47. In Bee’s 1988 income statement, the current portion of its provision for income taxes should be

a. $150,000  
b. $125,000  
c. $ 90,000  
d. $ 75,000

48. In Bee’s 1988 income statement, the deferred portion of its provision for income taxes should be

a. $60,000  
b. $50,000  
c. $45,000  
d. $40,000

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

1N90#49. On May 15, 1989, Munn, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1990 at a selling price of $500,000. During 1989, disposal costs incurred by Munn totaled $75,000. The segment had actual or estimated operating losses as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/ 1/89 to 5/14/89</td>
<td>$130,000</td>
</tr>
<tr>
<td>5/15/89 to 12/31/89</td>
<td>50,000</td>
</tr>
<tr>
<td>1/ 1/90 to 1/31/90</td>
<td>15,000</td>
</tr>
</tbody>
</table>

The carrying amount of the segment at the date of sale was expected to be $850,000. Before income taxes, what amount should Munn report as a loss on disposal of the segment in its 1989 income statement?

a. $490,000  
b. $475,000  
c. $440,000  
d. $425,000

1N90#50. On January 1, 1990, Hart, Inc. redeemed its 15-year bonds of $500,000 par value for 102. They were originally issued on January 1, 1978 at 98 with a maturity date of January 1, 1993. The bond issue costs relating to this transaction were $20,000. Hart amortizes discounts, premiums, and bond issue costs using the straight-line method. What amount of extraordinary loss should Hart recognize on the redemption of these bonds?

a. $16,000  
b. $12,000  
c. $10,000  
d. $0
2M90#47. On April 30, 1989, Carty Corp. approved a plan to dispose of a segment of its business. The estimated disposal loss is $480,000, including severance pay of $55,000 and employee relocation costs of $25,000, both of which are directly associated with the decision to dispose of the segment. Also included is the segment's estimated operating loss of $100,000 for the period from May 1, 1989, to the disposal date. A $120,000 operating loss from January 1, 1989, to April 30, 1989, is not included in the estimated disposal loss of $480,000. Before income taxes, what amount should be reported in Carty's income statement for the year ended December 31, 1989, as the loss from discontinued operations?

a. $600,000  
b. $480,000  
c. $455,000  
d. $425,000

1N89#46. On January 1, 1988, Dart, Inc. entered into an agreement to sell the assets and product line of its Jay Division, considered a segment of the business. The sale was consummated on December 31, 1988 and resulted in a gain on disposition of $400,000. The division's operations resulted in losses before income tax of $225,000 in 1988 and $125,000 in 1987. Dart's income tax rate is 30% for both years. In a comparative statement of income for 1988 and 1987, as components under the caption Discontinued Operations, Dart should report a gain (loss) amounting to

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>$122,500</td>
</tr>
<tr>
<td>1987</td>
<td>($87,500)</td>
</tr>
</tbody>
</table>

1N89#48. Lowe Corp. had the following gains, net of applicable taxes, during 1988:

- Foreign currency transaction gain due to major devaluation: $175,000  
- Gain from early extinguishment of Lowe's debt: $250,000

What amount should Lowe report as extraordinary gains in its 1988 income statement?

a. $425,000  
b. $250,000  
c. $175,000  
d. $0

In its income statement for the year ended December 31, 1988, how should Wall report the segment's operations from January 1 to April 30, 1988?

a. $600,000 and $750,000 should be included with revenues and expenses, respectively, as part of continuing operations.  
b. $150,000 should be reported as part of the loss on disposal of a segment.  
c. $150,000 should be reported as an extraordinary loss.  
d. $150,000 should be reported as a loss from operations of a discontinued segment.

1N88#45. On October 1, 1987, Burns Corp. approved a formal plan to sell Hall division, a business segment. The sale was scheduled to take place on March 31, 1988. Hall had operating income of $100,000 for the quarter ended December 31, 1987, and expected to incur an operating loss of $50,000 for the first quarter of 1988. Burns estimated that it would incur a $375,000 loss on the sale of Hall's assets. Burn's income tax rate for 1987 was 30%. In its 1987 income statement, Burns should report a loss on the disposal of Hall division of

a. $325,000  
b. $297,500  
c. $262,500  
d. $227,500

1N88#47. Burl Company incurred the following loss and realized the following gain during 1987:

- $50,000 loss as the result of an unanticipated strike by its employees.  
- $25,000 gain as the result of the early extinguishment of bonds payable.

Burl's income tax rate for 1987 was 30%. Burl's 1987 income statement should report an extraordinary loss and an extraordinary gain of

<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>

1N87#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></th>
<th>1986</th>
<th>1985</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$210,000</td>
<td>($150,000)</td>
</tr>
<tr>
<td>b.</td>
<td>$210,000</td>
<td>$0</td>
</tr>
<tr>
<td>c.</td>
<td>($270,000)</td>
<td>($150,000)</td>
</tr>
<tr>
<td>d.</td>
<td>($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>

E. Accounting Changes

1M91#59. On December 31, 1990, Rapp Co. changed inventory cost methods to FIFO from LIFO for financial statement and income tax purposes. The change will result in a $175,000 increase in the beginning inventory at January 1, 1990. Assuming a 30% income tax rate, the cumulative effect of this accounting change reported in the income statement for the year ended December 31, 1990, is
a. $175,000
b. $122,500
c. $ 52,500
d. $0

1M81#60. On January 1, 1985, Pell Corp. purchased a machine having an estimated useful life of 10 years and no salvage. The machine was depreciated by the double declining balance method for both financial statement and income tax reporting. On January 1, 1990, Pell changed to the straight-line method for financial statement reporting but not for income tax reporting. Accumulated depreciation at December 31, 1989, was $560,000. If the straight-line method had been used, the accumulated depreciation at December 31, 1989, would have been $420,000. Pell's enacted income tax rate for 1990 and thereafter is 30%. The amount shown in the 1990 income statement for the cumulative effect of changing to the straight-line method should be
a. $ 98,000 debit.
b. $ 98,000 credit.
c. $140,000 credit.
d. $140,000 debit.

1N90#51. On January 1, 1986, Flax Co. purchased a machine for $528,000 and depreciated it by the straight-line method using an estimated useful life of eight years with no salvage value. On January 1, 1989, Flax determined that the machine had a useful life of six years from the date of acquisition and will have a salvage value of $48,000. An accounting change was made in 1989 to reflect these additional data. The accumulated depreciation for this machine should have a balance at December 31, 1989 of
a. $292,000
b. $308,000
c. $320,000
d. $352,000

1N89#51. On December 31, 1988, Kerr, Inc. appropriately changed its inventory valuation method to FIFO cost from weighted-average cost for financial statement and income tax purposes. The change will result in a $700,000 increase in the beginning inventory at January 1, 1988. Assume a 30% income tax rate. The cumulative effect of this accounting change reported for the year ended December 31, 1988 is
a. $0
b. $210,000
c. $490,000
d. $700,000

1N89#52. On January 1, 1987, Aker Corp. acquired a machine at a cost of $200,000. It was to be depreciated on the straight line method over a five-year period with no residual value. Because of a bookkeeping error, no
depreciation was recognized in Aker's 1987 financial statements. The oversight was discovered during the preparation of Aker's 1988 financial statements. Depreciation expense on this machine for 1988 should be

a. $0
b. $40,000
c. $50,000
d. $80,000

1M89#52. On January 1, 1988, Roem Corp. changed its inventory method to FIFO from LIFO for both financial and income tax reporting purposes. The change resulted in a $500,000 increase in the January 1, 1988 inventory. Assume that the income tax rate for all years is 30%. The cumulative effect of the accounting change should be reported by Roem in its 1988

a. Retained earnings statement as a $350,000 addition to the beginning balance.
b. Income statement as a $350,000 cumulative effect of accounting change.
c. Retained earnings statement as a $500,000 addition to the beginning balance.
d. Income statement as a $500,000 cumulative effect of accounting change.

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

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

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

F. Earnings Per Share

1N90#52. Poe Co. had 300,000 shares of common stock issued and outstanding at December 31, 1988. No common stock was issued during 1989. On January 1, 1989, Poe issued 200,000 shares of nonconvertible preferred stock. During 1989, Poe declared and paid $75,000 cash dividends on the common stock and $60,000 on the preferred stock. Net income for the year ended December 31, 1989 was $330,000. What should be Poe's 1989 earnings per common share?

a. $1.10
b. $0.90
c. $0.85
d. $0.65

2N90#51. Peters Corp.'s capital structure was as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding shares of stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common</td>
<td>110,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Convertible preferred</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>8% convertible bonds</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

During 1989, Peters paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock and are considered common stock equivalents. The 8% bonds are convertible into 30,000 shares of common stock but are not considered common stock equivalents. Net income for 1989 was $850,000. Assume that the income tax rate is 30%. The primary earnings per share for 1989 is

a. $6.31
b. $6.54
c. $7.08
d. $7.45

1N89#54. Jones Corp.'s capital structure was as follows:

<table>
<thead>
<tr>
<th>December 31</th>
<th>1988</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding shares of stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common</td>
<td>110,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Convertible preferred</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>8% convertible bonds</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

During 1988, Jones paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock and are considered common stock equivalents. The 8% bonds are convertible into 30,000 shares of common stock but are not considered common stock equivalents. Net income for 1988 is $850,000. Assume that the income tax rate is 30%.

The fully diluted earnings per share for 1988 is

a. $5.48
b. $5.66
c. $5.81
d. $6.26
1M88#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:

- $896,000
- $898,800
- $900,000
- $901,200

1M88#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:

- 100,000
- 105,000
- 107,500
- 110,000

1M87#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?

- 735,000
- 780,000
- 885,000
- 930,000

1M87#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:

- $1.86
- $2.10
- $2.84
- $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:

- $2.40
- $2.80
- $3.60
- $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>Assets</th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>190,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>90,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>430,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>365,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Investment in Sub (equity method)</td>
<td>315,000</td>
<td>—</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,110,000</td>
<td>$350,000</td>
</tr>
</tbody>
</table>

**Liabilities and Stockholders' Equity**

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

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

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

*The items omitted can be found in other Content Specification Groups.*
Accounting Practice

INCOME STATEMENTS
For the Year Ended December 31, 1986

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

Additional information:

- On January 1, 1986, Par purchased for $300,000 all of Sub's $10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of $330,000 and $80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
- During 1986, Par and Sub paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.
- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.
- On June 30, 1986, Par issued 2,000 shares of common stock for $17 per share. There were no other changes in either Par's or Sub's common stock during 1986.
- Both Par and Sub paid income taxes at the rate of 40%.

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

VI. Other Financial Topics

A. Disclosures in Notes to the Financial Statements

1N90#53. Dean Co. acquired 100% of Morey Corp. prior to 1989. During 1989, the individual companies included in their financial statements the following:

<table>
<thead>
<tr>
<th></th>
<th>Dean</th>
<th>Morey</th>
</tr>
</thead>
<tbody>
<tr>
<td>Officers' salaries</td>
<td>$75,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Officers' expenses</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Loans to officers</td>
<td>125,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Intercompany sales</td>
<td>150,000</td>
<td>—</td>
</tr>
</tbody>
</table>

What amount should be reported as related party disclosures in the notes to Dean's 1989 consolidated financial statements?
   a. $150,000
   b. $155,000
   c. $175,000
   d. $330,000

1N90#54. Witt Corp. has outstanding at December 31, 1989 two long-term borrowings with annual sinking fund requirements and maturities as follows:

<table>
<thead>
<tr>
<th></th>
<th>Sinking fund requirements</th>
<th>Maturities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>$1,000,000</td>
<td>$ —</td>
</tr>
<tr>
<td>1990</td>
<td>1,500,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>1991</td>
<td>1,500,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>1992</td>
<td>2,000,000</td>
<td>2,500,000</td>
</tr>
<tr>
<td>1993</td>
<td>2,000,000</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

In the notes to its December 31, 1989 balance sheet, how should Witt report the above data?
   a. No disclosure is required.
   b. Only sinking fund payments totaling $8,000,000 for the next five years detailed by year need be disclosed.
   c. Only maturities totaling $9,500,000 for the next five years detailed by year need be disclosed.
   d. The combined aggregate of $17,500,000 of maturities and sinking fund requirements detailed by year should be disclosed.
Selected Questions

1N89#53. On January 1, 1987, West Co. entered into a ten-year lease for a manufacturing plant. The annual minimum lease payments are $100,000. In the notes to the December 31, 1988 financial statements, what amounts of subsequent years' lease payments should be disclosed?

<table>
<thead>
<tr>
<th>Amount for appropriate period</th>
<th>Aggregate amount for the period thereafter</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $100,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $300,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>c. $500,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>d. $500,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

2M89#16. In March 1988, an explosion occurred at Nilo Co.'s plant, causing damage to area properties. By May 1988, no claims had yet been asserted against Nilo. However, Nilo's management and legal counsel concluded that it was reasonably possible that Nilo would be held responsible for negligence, and that $3,000,000 would be a reasonable estimate of the damages. Nilo's $5,000,000 comprehensive public liability policy contains a $300,000 deductible clause. In Nilo's December 31, 1987 financial statements, for which the auditor's fieldwork was completed in April 1988, how should this casualty be reported?

a. As a footnote disclosing a possible liability of $3,000,000.

b. As an accrued liability of $300,000.

c. As a footnote disclosing a possible liability of $300,000.

d. No footnote disclosure or accrual is required for 1987 because the event occurred in 1988.

1N88#51. During 1987, Jones Company engaged in the following transactions:

- Salary expense to key employees who are also principal owners $100,000
- Sales to affiliated enterprises 250,000

Which of the two transactions would be disclosed as related party transactions in Jones's 1987 financial statements?

a. Neither transaction.

b. The $100,000 transaction only.

c. The $250,000 transaction only.

d. Both transactions.

1M88#46. A personal injury liability suit for $500,000 was brought against Ashe Corp. during 1987. Ashe's management and counsel concluded that it is reasonably possible that Ashe will be responsible for damages, and that $150,000 is a reasonable estimate of the damages. In Ashe's December 31, 1987 financial statements, how should this item be reported?

a. No disclosure in the financial statements or accrual is required.

b. As an accrued liability of $50,000 and as a disclosure in the financial statements indicating the exposure to an additional amount of loss up to $350,000.

c. As an accrued liability of $150,000 only.

d. As a disclosure only in the financial statements indicating the possible loss of $150,000.

C. Nonmonetary Transactions

2N90#18. Slad Co. exchanged similar productive assets with Gil Co. and, in addition, paid Gil cash of $100,000. The following information pertains to this exchange:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Carrying amounts</th>
<th>Fair values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relinquished by Gil</td>
<td>$75,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>Relinquished by Slad</td>
<td>40,000</td>
<td>40,000</td>
</tr>
</tbody>
</table>

On Slad's books, the assets acquired should be recorded at what amount?

a. $75,000

b. $100,000

c. $140,000

d. $175,000

2M90#58. On June 30, 1989, Finn, Inc. exchanged 2,000 shares of Edlow Corp. $30 par value common stock for a patent owned by Bisk Co. The Edlow stock was acquired in 1987 at a cost of $50,000. At the exchange date, Edlow common stock had a fair value of $40 per share, and the patent had a net carrying amount of $100,000 on Bisk's books. Finn should record the patent at

a. $50,000

b. $60,000

c. $80,000

d. $100,000

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

a. $0

b. $2,300

c. $3,700

d. $6,000

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

AP-81
D. Interim Financial Statements

1N90#55. Farr Corp. had the following transactions during the quarter ended March 31, 1990:

Loss on early extinguishment of debt $ 70,000
Payment of fire insurance premium for calendar year 1990 100,000

What amount should be included in Farr's income statement for the quarter ended March 31, 1990?

<table>
<thead>
<tr>
<th>Extraordinary loss</th>
<th>Insurance expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $70,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>b. $70,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>c. $17,500</td>
<td>$25,000</td>
</tr>
<tr>
<td>d. $0</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

2M90#43. An inventory loss from a permanent market decline of $360,000 occurred in May 1989. Cox Co. appropriately recorded this loss in May 1989 after its March 31, 1989 quarterly report was issued. What amount of inventory loss should be reported in Cox's quarterly income statement for the three months ended June 30, 1989?

a. $0
b. $90,000
c. $180,000
d. $360,000

1N89#49. Harper Co. incurred an apparently permanent inventory loss from market decline of $840,000 during June 1989. What amount of the inventory loss should be recognized in Harper's quarterly income statement for the three months ended June 30, 1989?

a. $210,000
b. $280,000
c. $420,000
d. $840,000

2M89#12. Vilo Corp. has estimated that total depreciation expense for the year ending December 31, 1989 will amount to $60,000, and that 1989 year-end bonuses to employees will total $120,000. In Vilo's interim income statement for the six months ended June 30, 1989, what is the total amount of expense relating to these two items that should be reported?

a. $0
b. $30,000
c. $90,000
d. $180,000

1N88#46. During the second quarter of 1988, Buzz Company sold a piece of equipment at a $12,000 gain. What portion of the gain should Buzz report in its income statement for the second quarter of 1988?

a. $12,000
b. $6,000
c. $4,000
d. $0

1M88#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>Cost</th>
<th>Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 2/1/87 $180,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Purchases 1,020,000</td>
<td>1,575,000</td>
</tr>
<tr>
<td>Markups, net 175,000</td>
<td></td>
</tr>
<tr>
<td>Sales 1,705,000</td>
<td></td>
</tr>
<tr>
<td>Estimated normal shoplifting losses 20,000</td>
<td></td>
</tr>
<tr>
<td>Markdowns, net 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

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

2M90#50. The following assets were among those that appeared on Baird Co.'s balance sheet at the end of the year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand bank deposits</td>
<td>$650,000</td>
</tr>
<tr>
<td>Net long-term receivables</td>
<td>400,000</td>
</tr>
<tr>
<td>Patents and trademarks</td>
<td>150,000</td>
</tr>
</tbody>
</table>
Selected Questions

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

a. $1,200,000  
b. $1,050,000  
c. $800,000  
d. $650,000

1N89#59. Information with respect to Bruno Co.'s cost of goods sold for 1988 is as follows:

<table>
<thead>
<tr>
<th>Historical cost</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, 1/1/88</td>
<td>$1,060,000</td>
</tr>
<tr>
<td>Production during 1988</td>
<td>5,580,000</td>
</tr>
<tr>
<td>Inventory, 12/31/88</td>
<td>2,520,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$4,120,000</td>
</tr>
</tbody>
</table>

Bruno estimates that the current cost per unit of inventory was $58 at January 1, 1988 and $72 at December 31, 1988. In Bruno's supplementary information restated into average current cost, the cost of goods sold for 1988 should be:

a. $5,040,000  
b. $4,550,000  
c. $4,410,000  
d. $4,060,000

2N89#13. The following items were among those that appeared on Rubi Co.'s books at the end of 1988:

- Merchandise inventory: $600,000  
- Loans to employees: 20,000

What amount should Rubi classify as monetary assets in preparing constant dollar financial statements?

a. $0  
b. $20,000  
c. $600,000  
d. $620,000

1N88#52. At December 31, 1987, Jannis Corp. owned two assets as follows:

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current cost</td>
<td>$100,000</td>
</tr>
<tr>
<td>Recoverable amount</td>
<td>$95,000</td>
</tr>
<tr>
<td>Amount</td>
<td>$80,000</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

1N88#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>Total</td>
<td>$2,015,000</td>
<td>31,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Rice estimates that the current cost per unit of inventory was $57 at January 1, 1986, and $71 at December 31, 1986.

54. In Rice's voluntary supplementary information restated into current cost, the December 31, 1986 inventory should be reported at:

a. $576,000  
b. $585,000  
c. $630,000  
d. $639,000

55. In Rice's voluntary supplementary information restated into current cost, the cost of goods sold for 1986 would be:

a. $1,920,000  
b. $1,944,000  
c. $2,100,000  
d. $2,130,000

AP-83
Details of Poe Corp.'s plant assets at December 31, 1986, are as follows:

<table>
<thead>
<tr>
<th>Year acquired</th>
<th>Percent depreciated</th>
<th>Historical cost</th>
<th>Estimated current cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>30</td>
<td>$200,000</td>
<td>$280,000</td>
</tr>
<tr>
<td>1985</td>
<td>20</td>
<td>60,000</td>
<td>76,000</td>
</tr>
<tr>
<td>1986</td>
<td>10</td>
<td>80,000</td>
<td>88,000</td>
</tr>
</tbody>
</table>

Poe calculates depreciation at 10% per annum, using the straight-line method. A full year's depreciation is charged in the year of acquisition. There were no disposals of plant assets. In Poe's voluntary supplementary information restated into current cost, the net current cost (after accumulated depreciation) of the plant assets at December 31, 1986, should be stated as:

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

F. Gain Contingencies

On November 1, 1990, Beni Corp. was awarded a judgment of $1,500,000 in connection with a lawsuit. The decision is being appealed by the defendant, and it is expected that the appeal process will be completed by the end of 1991. Beni's attorney feels that it is highly probable that an award will be upheld on appeal, but that the judgment may be reduced by an estimated 40%. In addition to footnote disclosure, what amount should be reported as a receivable in Beni's balance sheet at December 31, 1990?

a. $1,500,000
b. $900,000
c. $600,000
d. $0

On January 3, 1989, Ard Corp. owned a machine that had cost $60,000. The accumulated depreciation was $50,000, estimated salvage value was $5,000, and fair market value was $90,000. On January 4, 1989, this machine was irreparably damaged by Rice Corp. and became worthless. In October 1989, a court awarded damages of $90,000 against Rice in favor of Ard. At December 31, 1989, the final outcome of this case was awaiting appeal and was, therefore, uncertain. However, in the opinion of Ard's attorney, Rice's appeal will be denied. At December 31, 1989, what amount should Ard accrue for this gain contingency?

a. $90,000
b. $80,000
c. $75,000
d. $0

Dodd Corp. is preparing its December 31, 1989 financial statements and must determine the proper accounting treatment for the following situations:

- For the year ended December 31, 1989, Dodd has a loss carryforward of $180,000 available to offset future taxable income. However, there are no temporary differences.
- On December 30, 1989, Dodd received a $200,000 offer for its patent. Dodd's management is considering whether to sell the patent. The offer expires on February 28, 1990. The patent has a carrying amount of $100,000 at December 31, 1989.

Assume a current and future income tax rate of 30%. In its 1989 income statement, Dodd should recognize an increase in net income of

a. $0
b. $54,000
c. $70,000
d. $124,000

In May 1985, Croft Co. filed suit against Walton, Inc. seeking $950,000 damages for patent infringement. A court verdict in November 1988 awarded Croft $750,000 in damages, but Walton's appeal is not expected to be decided before 1990. Croft's counsel believes it is probable that Croft will be successful against Walton for an estimated amount in the range between $400,000 and $550,000, with $500,000 considered the most likely amount. What amount should Croft record as revenue from the lawsuit in the year ended December 31, 1988?

a. $750,000
b. $500,000
c. $400,000
d. $0

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

For the year ended December 31, 1987, Colt Corp. has a loss carryforward of $180,000 available to offset future taxable income. At December 31, 1987, realization of the tax benefit of the carryforward is probable, but not assured beyond any reasonable doubt. Assume an income tax rate of 30%. What amount of the tax benefit should be reported in Colt's 1987 income statement?

a. $180,000
b. $126,000
c. $54,000
d. $0
Selected Questions

G. Segments and Lines of Business

2M91#11. The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31, 1990:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales to unaffiliated customers</th>
<th>Intersegment sales</th>
<th>Total revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alo</td>
<td>$5,000</td>
<td>$3,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Bix</td>
<td>8,000</td>
<td>4,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Cee</td>
<td>4,000</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>Dil</td>
<td>43,000</td>
<td></td>
<td>59,000</td>
</tr>
<tr>
<td>Combined</td>
<td>60,000</td>
<td>23,000</td>
<td>83,000</td>
</tr>
<tr>
<td>Elimination</td>
<td>—</td>
<td></td>
<td>(23,000)</td>
</tr>
<tr>
<td>Consolidated</td>
<td>$60,000</td>
<td></td>
<td>$60,000</td>
</tr>
</tbody>
</table>

In conformity with the revenue test, Timm's reportable segments were:

a. Only Dil.
b. Only Bix and Dil.
c. Only Alo, Bix, and Dil.
d. Alo, Bix, Cee, and Dil.

2M91#16. Graf Corp. discloses supplemental industry segment information. The following information is available for 1990:

<table>
<thead>
<tr>
<th>Segment</th>
<th>Sales</th>
<th>Traceable operating expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Y</td>
<td>800,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Z</td>
<td>600,000</td>
<td>350,000</td>
</tr>
<tr>
<td></td>
<td>$2,400,000</td>
<td>$1,450,000</td>
</tr>
</tbody>
</table>

Additional 1990 expenses, not included above, are as follows:
- Indirect operating expenses $360,000
- General corporate expenses 240,000

Appropriate common expenses are allocated to segments based on the ratio of a segment's sales to total sales. Segment Z's 1990 operating profit was:

a. $100,000
b. $130,000
c. $160,000
d. $250,000

2M90#56. Correy Corp. and its divisions are engaged solely in manufacturing operations. The following data (consistent with prior years' data) pertain to the industries in which operations were conducted for the year ended December 31, 1989:

<table>
<thead>
<tr>
<th>Industry</th>
<th>Total revenue</th>
<th>Operating profit</th>
<th>Identifiable assets at 12/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$10,000,000</td>
<td>$1,750,000</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>B</td>
<td>8,000,000</td>
<td>1,400,000</td>
<td>17,500,000</td>
</tr>
<tr>
<td>C</td>
<td>6,000,000</td>
<td>1,200,000</td>
<td>12,500,000</td>
</tr>
<tr>
<td>D</td>
<td>3,000,000</td>
<td>550,000</td>
<td>7,500,000</td>
</tr>
<tr>
<td>E</td>
<td>4,250,000</td>
<td>675,000</td>
<td>7,000,000</td>
</tr>
<tr>
<td>F</td>
<td>1,500,000</td>
<td>225,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>$32,750,000</td>
<td>$5,800,000</td>
<td>$67,500,000</td>
</tr>
</tbody>
</table>

In its segment information for 1989, how many reportable segments does Correy have?

a. Three
b. Four
c. Five
d. Six

1N87#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 E</th>
<th>Segment W</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$750,000</td>
</tr>
<tr>
<td>Traceable operating expenses</td>
<td>325,000</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. $150,000  
d. $100,000

H. Employee Benefits

2M91#17. The following information pertains to the 1990 activity of Rail Corp.’s defined benefit pension plan:

| Service cost | $300,000 |
| Return on plan assets | 80,000 |
| Interest cost on pension benefit obligation | 164,000 |
| Amortization of actuarial loss | 30,000 |
| Amortization of unrecognized net obligation | 70,000 |

Rail’s 1990 pension cost was  
a. $316,000  
b. $484,000  
c. $574,000  
d. $644,000

2M90#16. The following information pertains to Seda Co.’s pension plan:

| Actuarial estimate of projected benefit obligation at 1/1/89 | $72,000 |
| Assumed discount rate | 10% |
| Service costs for 1989 | 18,000 |
| Pension benefits paid during 1989 | 15,000 |

If no change in actuarial estimates occurred during 1989, Seda’s projected benefit obligation at December 31, 1989 was  
a. $64,200  
b. $75,000  
c. $79,200  
d. $82,200

2M90#53. Gavin Co. grants all employees two weeks of paid vacation for each full year of employment. Unused vacation time can be accumulated and carried forward to succeeding years and will be paid at the salaries in effect when vacations are taken or when employment is terminated. There was no employee turnover in 1989. Additional information relating to the year ended December 31, 1989 is as follows:

| Liability for accumulated vacations at 12/31/88 | $35,000 |
| Pre-1989 accrued vacations taken from 1/1/89 to 9/30/89 (the authorized period for vacations) | 20,000 |
| Vacations earned for work in 1989 (adjusted to current rates) | 30,000 |

Gavin granted a 10% salary increase to all employees on October 1, 1989, its annual salary increase date. For the year ended December 31, 1989, Gavin should report vacation pay expense of  
a. $45,000  
b. $33,500  
c. $31,500  
d. $30,000

1N89#56. On January 1, 1988, Heath Corp. established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1988 were as follows:

- On April 1, 1988, Heath contributed $45,000 cash and 3,000 shares of its $10 par value common stock to the ESOP. On this date, the market price of the stock was $18 a share.
- On October 1, 1988, the ESOP borrowed $100,000 from Union National Bank and acquired 6,000 shares of Heath’s common stock in the open market at $17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Heath.
- On December 15, 1988, the ESOP distributed 8,000 shares of Heath’s common stock to employees of Heath in accordance with the plan formula. On this date, the market price of the stock was $20 a share.

In its 1988 income statement, what amount should Heath report as compensation expense relating to the ESOP?  
a. $99,000  
b. $155,000  
c. $199,000  
d. $259,000

2M89#18. On May 1, 1988, Gray Corp. granted stock options to certain key employees as additional compensation. The options were for 1,000 shares of Gray’s $1 par value common stock at an option price of $30 per share. The market price of this stock on May 1, 1988 was $40 per share. The options were exercisable beginning January 2, 1989 and expire on December 31, 1990. On March 1, 1989, when Gray’s stock was trading at $42 per share, all the options were exercised. The total amount of pretax compensation that Gray should record for 1988 is  
a. $1,000  
b. $5,000  
c. $10,000  
d. $12,000

2M89#19. Rail Corp. has an incentive compensation plan under which a branch manager receives 10% of the branch’s income after deduction of the bonus but before deduction of income tax. Branch income for 1988 before the bonus and income tax was $165,000. The tax rate was 30%. The 1988 bonus amounted to  
a. $12,600  
b. $15,000  
c. $16,500  
d. $18,000

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**Selected Questions**

**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:

<table>
<thead>
<tr>
<th>Liability for accumulated vacations at 12/31/85</th>
<th>$25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-1986 accrued vacations taken from 1/1/86 to 9/30/86 (the authorized period for vacations)</td>
<td>15,000</td>
</tr>
<tr>
<td>Vacations earned for work in 1986 (adjusted to current rates)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

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

**I. Analysis of Financial Statements**

**2M81#18.** The following information was extracted from Gil Co.'s December 31, 1990, balance sheet:

- **Noncurrent assets:**
  - Long-term investments in marketable equity securities (carried at lower of cost or market) $96,450

- **Stockholders' equity:**
  - Net unrealized loss on long-term investments in marketable equity securities (19,800)

- **Historical cost of the long-term investments in marketable equity securities was**
  a. $63,595
  b. $76,650
  c. $96,450
  d. $116,250

**1N90#57.** During 1989, Rand Co. purchased $960,000 of inventory. The cost of goods sold for 1989 was $900,000, and the ending inventory at December 31, 1989 was $180,000. What was the inventory turnover for 1989?
   a. 6.4
   b. 6.0
   c. 5.3
   d. 5.0

**2M99#55.** The following data pertain to Ruhl Corp.'s operations for the year ended December 31, 1989:

<table>
<thead>
<tr>
<th>Operating income</th>
<th>$800,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>100,000</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>700,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>210,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$490,000</td>
</tr>
</tbody>
</table>

The times interest earned ratio is
   a. 8.0 to 1
   b. 7.0 to 1
   c. 5.6 to 1
   d. 4.9 to 1
The following data pertain to Thorne Corp. for the calendar year 1988:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$240,000</td>
</tr>
<tr>
<td>Dividends paid on common stock</td>
<td>120,000</td>
</tr>
<tr>
<td>Common stock outstanding</td>
<td>300,000</td>
</tr>
</tbody>
</table>

The market price per share of Thorne's common stock at December 31, 1988 was $12. The price-earnings ratio at December 31, 1988 was:

a. 9.6 to 1  
b. 10.0 to 1  
c. 15.0 to 1  
d. 30.0 to 1

Items 14 and 15 are based on the following:

Rey, Inc.
Selected Financial Data
December 31, 1988

<table>
<thead>
<tr>
<th>Description</th>
<th>1988</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$170,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>450,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>540,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Short-term marketable securities</td>
<td>80,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Land and building (net)</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Mortgage payable - current portion</td>
<td>60,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>240,000</td>
<td>220,000</td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>100,000</td>
<td>140,000</td>
</tr>
</tbody>
</table>

Net credit sales totaled $3,000,000 and $2,000,000 for the years ended December 31, 1988 and 1987, respectively.

14. At December 31, 1988, Rey's quick (acid test) ratio was:

a. 1.50 to 1  
b. 1.75 to 1  
c. 2.06 to 1  
d. 3.10 to 1

15. For 1988, Rey's accounts receivable turnover was:

a. 1.13  
b. 1.50  
c. 6.67  
d. 7.06

The following information is available from Timber Corp.'s financial records for 1987:

<table>
<thead>
<tr>
<th>Sales</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net credit sales</td>
<td>$500,000</td>
</tr>
<tr>
<td>Net cash sales</td>
<td>250,000</td>
</tr>
<tr>
<td>Total</td>
<td>$750,000</td>
</tr>
</tbody>
</table>

How many times did Timber's accounts receivable turnover in 1987?

a. 15  
b. 12  
c. 10  
d. 8

Selected information for Cain Corp. for the year ended December 31, 1987 follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average days' sales in inventories</td>
<td>124</td>
</tr>
<tr>
<td>Average days' sales in accounts receivable</td>
<td>48</td>
</tr>
</tbody>
</table>

The average number of days in the operating cycle for 1987 was:

a. 172  
b. 124  
c. 86   
d. 76

Flax Company's accounting records disclosed the following information as of and for the year ended December 31, 1986:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net credit sales</td>
<td>$3,150,000</td>
</tr>
<tr>
<td>Net cash sales</td>
<td>630,000</td>
</tr>
<tr>
<td>Accounts receivable at beginning</td>
<td>500,000</td>
</tr>
<tr>
<td>Accounts receivable at end</td>
<td>900,000</td>
</tr>
</tbody>
</table>

Flax's accounts receivable turnover is:

a. 5.4 times  
b. 4.5 times  
c. 4.2 times  
d. 3.5 times

On December 31, 1985 and 1986, Taft Corporation had 100,000 shares of common stock and 50,000 shares of noncumulative and nonconvertible preferred stock issued and outstanding. Additional information is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stockholders' equity at 12/31/86</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Net income year ended 12/31/86</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Dividends on preferred stock year ended 12/31/86</td>
<td>300,000</td>
</tr>
<tr>
<td>Market price per share of common stock at 12/31/86</td>
<td>72</td>
</tr>
</tbody>
</table>

The price-earnings ratio on common stock at December 31, 1986 was:

a. 5 to 1  
b. 6 to 1  
c. 8 to 1  
d. 9 to 1
**Selected Questions**

1M87  
**Items 54 and 55** are based on the following data:

### Drew Company  
**Selected Financial Data**

**As of December 31,**

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

**Year Ended December 31,**

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

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

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

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**

#### Assets

<table>
<thead>
<tr>
<th></th>
<th>Par</th>
<th>Sub</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current 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>

### 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>

*The items omitted can be found in other Content Specification Groups.*
**Additional information:**

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

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

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

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

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

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

**J. Development Stage Enterprises**

**1N90#58.** Lex Corp. was a development stage enterprise from October 10, 1987 (inception) to December 31, 1988. The year ended December 31, 1989 is the first year in which Lex is an established operating enterprise. The following are among the costs incurred by Lex:

<table>
<thead>
<tr>
<th>For the period</th>
<th>For the year ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/10/87 to 12/31/88</td>
<td>12/31/89</td>
</tr>
<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>225,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,235,000</strong></td>
</tr>
</tbody>
</table>

From its inception through the period ended December 31, 1989, what is the total amount of costs incurred by Lex that should be charged to operations?

- a. $3,425,000
- b. $2,250,000
- c. $1,775,000
- d. $1,350,000

**2M90#52.** Lind Corp. was a development stage enterprise from its inception on October 10, 1987 to December 31, 1988. The following were among Lind's expenditures for this period:

| Leasehold improvements, equipment, and furniture | $1,200,000 |
| Research and development | 850,000 |
| Laboratory operations | 175,000 |
| General and administrative | 275,000 |

The year ended December 31, 1989 was the first year in which Lind was an established operating enterprise. For the period ended December 31, 1988, what total amount of expenditures should Lind have capitalized?

- a. $2,500,000
- b. $2,225,000
- c. $2,050,000
- d. $1,200,000

**1N89#4.** Chester Corp. was a development stage enterprise from its inception on September 1, 1987 to December 31, 1988. The following information was taken from Chester's accounting records for the above period:

| Net sales | $1,350,000 |
| Cost of sales | 1,000,000 |
| Selling, general, and administrative expenses | 400,000 |
| Research and development costs | 300,000 |
| Interest expense | 100,000 |

For the period September 1, 1987 to December 31, 1988, what amount should Chester report as net loss?

- a. $50,000
- b. $150,000
- c. $350,000
- d. $450,000

**1N88#55.** On July 2, 1988, Creighton Corp. was formed for the purpose of presenting a musical comedy show. The show was scheduled to be presented only on December 30, 1988. A total of 1,000 tickets were sold between July 2 and December 30, including 50 tickets sold between July 2 and July 31. During July, Creighton paid $12,000 in salaries to actors involved in rehearsals during that month. On July 31, Creighton was consid-
Selected Questions

cred to be in the development stage of its principal operation. In an income statement prepared for the period July 2 through July 31, 1988, Creighton should report salary expense of

a. $0
b. $ 600
c. $ 2,000
d. $12,000

1M88
Items 58 and 59 are based on the following information:

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

<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,</td>
<td></td>
</tr>
<tr>
<td>equipment, and furniture</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>$150,000</td>
<td></td>
</tr>
<tr>
<td>Security deposits</td>
<td>60,000</td>
</tr>
<tr>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Research and development</td>
<td>750,000</td>
</tr>
<tr>
<td>450,000</td>
<td></td>
</tr>
<tr>
<td>Laboratory operations</td>
<td>175,000</td>
</tr>
<tr>
<td>275,000</td>
<td></td>
</tr>
<tr>
<td>General and administrative</td>
<td>250,000</td>
</tr>
<tr>
<td>400,000</td>
<td></td>
</tr>
</tbody>
</table>

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

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

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

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

K. Personal Financial Statements

2M91#8. Moran is preparing a personal statement of financial condition as of April 30, 1991. Included in Moran's assets are the following:

- Jewelry with a fair value aggregating $35,000 based on an independent appraisal on April 30, 1991, for insurance purposes. This jewelry was acquired by purchase and gift over a 10-year period and has a total tax basis of $20,000.

At what total amount should the Crow stock and jewelry be reported in Moran's April 30, 1991, personal statement of financial condition?

a. $372,500
b. $357,500
c. $250,000
d. $235,000

2M91#9. The following information pertains to marketable equity securities owned by Kent:

<table>
<thead>
<tr>
<th>Stock</th>
<th>Fair value at December 31, 1990</th>
<th>Fair value at December 31, 1989</th>
<th>Cost in 1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Mfg., Inc.</td>
<td>$95,500</td>
<td>$93,000</td>
<td>$89,900</td>
</tr>
<tr>
<td>Tri Corp.</td>
<td>3,400</td>
<td>5,600</td>
<td>3,600</td>
</tr>
<tr>
<td>Zee, Inc.</td>
<td>10,300</td>
<td>15,000</td>
<td></td>
</tr>
</tbody>
</table>

The Zee stock was sold in January 1990 for $10,200. In Kent's personal statement of financial condition at December 31, 1990, what amount should be reported for marketable equity securities?

a. $93,300
b. $93,500
c. $94,100
d. $98,900

2M91#10. The estimated current values of Lane's personal assets at December 31, 1990, totaled $1,000,000, with tax bases aggregating $600,000. Included in these assets was a vested interest in a deferred profit-sharing plan with a current value of $80,000 and a tax basis of $70,000. The estimated current amounts of Lane's personal liabilities equaled their tax bases at December 31, 1990. Lane's 1990 effective income tax rate was 30%. In Lane's personal statement of financial condition at December 31, 1990, what amount should be provided for estimated income taxes relating to the excess of current values over tax bases?

a. $120,000
b. $117,000
c. $ 3,000
d. $0

1M90#59. Mrs. Taft owns a $150,000 insurance policy on her husband's life. The cash value of the policy is $125,000, and there is a $50,000 loan against the policy. In the Tafts' personal statement of financial condition at December 31, 1989, what amount should be shown as an investment in life insurance?

a. $150,000
b. $125,000
c. $100,000
d. $ 75,000
**Accounting Practice**

**2M89#59.** Dale Hall’s holdings at December 31, 1989 included the following:

- 5,000 shares of Arno Corp. common stock purchased in 1984 for $85,000. The market value of the stock was $120,000 at December 31, 1989.
- A life insurance policy with a cash value of $50,000 at December 31, 1989.

In Hall’s December 31, 1989 personal statement of financial condition, the above items should be reported at

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$170,000</td>
</tr>
<tr>
<td>b.</td>
<td>$135,000</td>
</tr>
<tr>
<td>c.</td>
<td>$120,000</td>
</tr>
<tr>
<td>d.</td>
<td>$ 85,000</td>
</tr>
</tbody>
</table>

**1M88#58.** John Holt owns 50% of the common stock of Brett Corp. Holt paid $25,000 for this stock in 1983. At December 31, 1988, it was ascertained that Holt’s 50% stock ownership in Brett had a current value of $185,000. Brett’s cumulative net income and cash dividends declared for the five years ended December 31, 1988 were $300,000 and $30,000 respectively. In Holt’s personal statement of financial condition at December 31, 1988, what amount should be reported as his net investment in Brett?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>b.</td>
<td>$160,000</td>
</tr>
<tr>
<td>c.</td>
<td>$175,000</td>
</tr>
<tr>
<td>d.</td>
<td>$185,000</td>
</tr>
</tbody>
</table>

**2M89#17.** Ron Alda owns 100% of Hako Corp.’s outstanding capital stock. Alda paid $60,000 for this stock in 1980. At December 31, 1988, the book value of Hako’s net assets amounted to $300,000. It has been ascertained that Alda’s 100% stock ownership in Hako had a current value of $500,000 at December 31, 1988. Alda has an employment contract with Hako under which Alda is to receive a salary of $100,000 annually for a ten-year period beginning in January 1988. In Alda’s personal statement of financial condition at December 31, 1988, what amount should be shown as his net investment in Hako?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>b.</td>
<td>$100,000</td>
</tr>
<tr>
<td>c.</td>
<td>$300,000</td>
</tr>
<tr>
<td>d.</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

**1M88#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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>c.</td>
<td>$ 95,000</td>
</tr>
<tr>
<td>d.</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

**1M87#56.** 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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$497,500</td>
</tr>
<tr>
<td>b.</td>
<td>$550,000</td>
</tr>
<tr>
<td>c.</td>
<td>$562,500</td>
</tr>
<tr>
<td>d.</td>
<td>$650,000</td>
</tr>
</tbody>
</table>

**L. Combined Financial Statements**

**2M91**

**Items 19 and 20** are based on the following:

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb’s cost. During 1990, merchandise that cost Webb $40,000 was sold to
19. By what amount was unadjusted revenue overstated in the combined income statement for 1990?
   a. $16,000
   b. $40,000
   c. $56,000
   d. $81,200

20. What amount should be eliminated from cost of goods sold in the combined income statement for 1990?
   a. $56,000
   b. $40,000
   c. $24,000
   d. $16,000

1N89#50. Mr. Cord owns four corporations. Combined financial statements are being prepared for these corporations, which have intercompany loans of $200,000 and intercompany profits of $500,000. What amount of these intercompany loans and profits should be included in the combined financial statements?

<table>
<thead>
<tr>
<th></th>
<th>Intercompany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>Profits</td>
</tr>
<tr>
<td>a. $200,000</td>
<td>$0</td>
</tr>
<tr>
<td>b. $200,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>c. $0</td>
<td>$0</td>
</tr>
<tr>
<td>d. $0</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

1N89#55. Selected data for two subsidiaries of Dunn Corp. taken from December 31, 1988 pre-closing trial balances are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Banks Co.</th>
<th>Lamm Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Shipment to Banks</td>
<td>$ —</td>
<td>$150,000</td>
</tr>
<tr>
<td>Shipment from Lamm</td>
<td>200,000</td>
<td>—</td>
</tr>
<tr>
<td>Intercompany inventory profit on total shipments</td>
<td>—</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Additional data relating to the December 31, 1988 inventory are as follows:

Inventory acquired from outside parties $175,000 $250,000
Inventory acquired from Lamm 60,000 —

At December 31, 1988, the inventory reported on the combined balance sheet of the two subsidiaries should be
   a. $425,000
   b. $435,000
   c. $470,000
   d. $485,000

1N88#58. At December 31, 1987, Spud Corp. owned 80% of Jenkins Corp.'s common stock and 90% of Thompson Corp.'s common stock. Jenkins' 1987 net income was $100,000 and Thompson's 1987 net income was $200,000. Thompson and Jenkins had no intercompany ownership or transactions during 1987. Combined 1987 financial statements are being prepared for Thompson and Jenkins in contemplation of their sale to an outside party. In the combined income statement, combined net income should be reported at
   a. $210,000
   b. $260,000
   c. $280,000
   d. $300,000

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

<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></td>
<td>Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
</tr>
<tr>
<td>Inventory, 1/1/86</td>
<td>$120,000</td>
<td>$ —</td>
</tr>
<tr>
<td>Purchases</td>
<td>190,000</td>
<td>85,000</td>
</tr>
<tr>
<td>Shipment to Bix</td>
<td>(80,000)</td>
<td>—</td>
</tr>
<tr>
<td>Shipment from Ash</td>
<td>—</td>
<td>100,000</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:

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

At December 31, 1986, the inventory reported on the combined balance sheet of the two unconsolidated subsidiaries should be

a. $150,000
b. $160,000
c. $174,000
d. $180,000

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2N89
Items 33 through 35 are based on the following information pertaining to Arp Co.'s manufacturing operations:

<table>
<thead>
<tr>
<th>Inventories</th>
<th>3/1/89</th>
<th>3/31/89</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$36,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Work-in-process</td>
<td>18,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>54,000</td>
<td>72,000</td>
</tr>
</tbody>
</table>

Addtional information for the month of March 1989:

Direct materials purchased $84,000
Direct labor payroll 60,000
Direct labor rate per hour 7.50
Factory overhead rate per direct labor hour 10.00

33. For the month of March 1989, prime cost was
a. $ 90,000
b. $120,000
c. $144,000
d. $150,000

34. For the month of March 1989, conversion cost was
a. $ 90,000
b. $140,000
c. $144,000
d. $170,000

35. For the month of March 1989, cost of goods manufactured was
a. $218,000
b. $224,000
c. $230,000
d. $236,000

B. Process and Job Order Costing

2N89#39. Axe Co. has a job order cost system. The following debits (credits) appeared in the work-in-process account for the month of March 1989:

<table>
<thead>
<tr>
<th>March</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Balance</td>
<td>$2,000</td>
</tr>
<tr>
<td>31</td>
<td>Direct materials</td>
<td>12,000</td>
</tr>
<tr>
<td>31</td>
<td>Direct labor</td>
<td>8,000</td>
</tr>
<tr>
<td>31</td>
<td>Factory overhead</td>
<td>6,400</td>
</tr>
<tr>
<td>31</td>
<td>To finished goods</td>
<td>(24,000)</td>
</tr>
</tbody>
</table>

Axe applies overhead to production at a predetermined rate of 80% based on direct labor cost. Job No. 9, the only job still in process at the end of March 1989, has been charged with direct labor of $1,000. The amount of direct materials charged to Job No. 9 was

a. $12,000
b. $ 4,400
c. $ 2,600
d. $ 1,500
Selected Questions

**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>Work-in-process, April 1</th>
<th>Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>(60% complete as to conversion cost)</td>
<td>3,000</td>
</tr>
<tr>
<td>Started in April</td>
<td>25,000</td>
</tr>
<tr>
<td>Completed</td>
<td>20,000</td>
</tr>
<tr>
<td>Work-in-process, April 30</td>
<td>8,000</td>
</tr>
</tbody>
</table>

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

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

**C. Standard Costing**

**2N89#26.** Dahl Co. uses a standard costing system in connection with the manufacture of a "one size fits all" article of clothing. Each unit of finished product contains 2 yards of direct material. However, a 20% direct material spoilage calculated on input quantities occurs during the manufacturing process. The cost of the direct material is $3 per yard. The standard direct material cost per unit of finished product is:

a. $4.80
b. $6.00
c. $7.20
d. $7.50

**2M87**

*Items 32 and 33* are based on the following data:

The following processing standards have been set for Duo Co.'s clerical workers:

| Number of hours per 1,000 papers processed | 150 |
| Normal number of papers processed per year | 1,500,000 |
| Wage rate per 1,000 papers | $600 |
| Standard variable cost of processing 1,500,000 papers | $900,000 |
| Fixed costs per year | $150,000 |

The following information pertains to the 1,200,000 papers that were processed during 1986:

| Total cost | $915,000 |
| Labor cost | $760,000 |
| Labor hours | 190,000 |

**32.** For 1986, Duo's expected total cost to process the 1,200,000 papers, assuming standard performance, should be:

a. $910,000
b. $900,000
c. $870,000
d. $840,000

**D. Joint and By-Product Costing, Spoilage, Waste, and Scrap**

**2N89#32** in manufacturing its products for the month of March 1989, Elk Co. incurred normal spoilage of $5,000 and abnormal spoilage of $9,000. How much spoilage cost should Elk charge as a period cost for the month of March 1989?

a. $0
b. $5,000
c. $9,000
d. $14,000

**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

**E. Absorption and Variable Costing**

**2N89#25.** West Co.'s 1988 manufacturing costs were as follows:

Direct materials and direct labor $700,000
Other variable manufacturing costs 100,000
Depreciation of factory building and manufacturing equipment 80,000
Other fixed manufacturing overhead 18,000

What amount should be considered product cost for external reporting purposes?

a. $700,000
b. $800,000
c. $880,000
d. $898,000

**2M87**

*The item omitted can be found in other Content Specification Groups.*
2N89#30. During the month of April, Vane Co. produced and sold 10,000 units of a product. Manufacturing and selling costs incurred during April were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials and direct labor</td>
<td>$400,000</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>90,000</td>
</tr>
<tr>
<td>Fixed manufacturing overhead</td>
<td>20,000</td>
</tr>
<tr>
<td>Variable selling costs</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The product's unit cost under direct (variable) costing was

a. $49
b. $50
c. $51
d. $52

2M87#29. During May, Roy Co. produced 10,000 units of Product X. Costs incurred by Roy during May were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>$10,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>20,000</td>
</tr>
<tr>
<td>Variable manufacturing overhead</td>
<td>5,000</td>
</tr>
<tr>
<td>Variable selling and general</td>
<td>3,000</td>
</tr>
<tr>
<td>Fixed manufacturing overhead</td>
<td>9,000</td>
</tr>
<tr>
<td>Fixed selling and general</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$51,000</strong></td>
</tr>
</tbody>
</table>

Under absorption costing, Product X's unit cost was

a. $5.10
b. $4.40
c. $3.80
d. $3.50

G. Breakeven and Cost-Volume-Profit Analysis

2N89#27. The following information pertains to Sisk Co.:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (25,000 units)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Direct materials and direct labor</td>
<td>150,000</td>
</tr>
</tbody>
</table>

Factory overhead:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
<td>20,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>35,000</td>
</tr>
</tbody>
</table>

Selling and general expenses:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
<td>5,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Sisk's breakeven point in number of units is

a. 4,924
b. 5,000
c. 6,250
d. 9,286

2N89#28. The following information pertains to Mete Co.:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$400,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>80,000</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Mete's breakeven point in sales dollars is

a. $ 20,000
b. $ 25,000
c. $ 80,000
d. $100,000
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 break-even point in sales dollars was
   a. $16,667  
   b. $25,000  
   c. $30,000  
   d. $70,000

H. Capital Budgeting Techniques

2N89#36. Kern Co. is planning to invest in a two-year project that is expected to yield cash flows from operations, net of income taxes, of $50,000 in the first year and $80,000 in the second year. Kern requires an internal rate of return of 15%. The present value of $1 for one period at 15% is 0.870 and for two periods at 15% is 0.756. The future value of $1 for one period at 15% is 1.150 and for two periods at 15% is 1.323. The maximum that Kern should invest immediately is
   a. $81,670  
   b. $103,980  
   c. $130,000  
   d. $163,340

2N89#40. Doro Co. is considering the purchase of a $100,000 machine that is expected to result in a decrease of $25,000 per year in cash expenses after taxes. This machine, which has no residual value, has an estimated useful life of 10 years and will be depreciated on a straight-line basis. For this machine, the accounting rate of return based on initial investment would be
   a. 10%  
   b. 15%  
   c. 25%  
   d. 35%

2N87

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.

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.

I. Performance Analysis

2N89

Items 37 and 38 are based on the following information pertaining to Yola Co.'s East Division for 1988:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$620,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>500,000</td>
</tr>
<tr>
<td>Traceable fixed costs</td>
<td>100,000</td>
</tr>
<tr>
<td>Average invested capital</td>
<td>50,000</td>
</tr>
<tr>
<td>Imputed interest rate on average invested capital</td>
<td>18%</td>
</tr>
</tbody>
</table>

37. The return on investment was
   a. 40.00%  
   b. 29.00%  
   c. 18.00%  
   d. 8.33%

38. The residual income was
   a. $3,600  
   b. $9,000  
   c. $11,000  
   d. $20,000

*The items omitted can be found in other Content Specification Groups.
Accounting Practice

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>Description</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 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

J. Other

2N89#21. The following information pertains to three shipping terminals operated by Krag Corp.:

<table>
<thead>
<tr>
<th>Terminal</th>
<th>Percentage of cargo handled</th>
<th>Percentage of error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>50</td>
<td>2</td>
</tr>
<tr>
<td>Air</td>
<td>40</td>
<td>4</td>
</tr>
<tr>
<td>Sea</td>
<td>10</td>
<td>14</td>
</tr>
</tbody>
</table>

Krag's internal auditor randomly selects one set of shipping documents, ascertaining that the set selected contains an error. The probability that the error occurred in the Land Terminal is
   a. 2%
   b. 10%
   c. 25%
   d. 50%

2N89#22. Mili Co. plans to discontinue a division with a $20,000 contribution to overhead. Overhead allocated to the division is $50,000, of which $5,000 cannot be eliminated. The effect of this discontinuance on Mili’s pretax income would be an increase of
   a. $ 5,000
   b. $20,000
   c. $25,000
   d. $30,000

2N89#23. Diva Co. wants to establish a selling price that will yield a gross margin of 40% on sales of a product whose cost is $12.00 per unit. The selling price should be
   a. $16.80
   b. $19.20
   c. $20.00
   d. $30.00

2N89#24. Palo Corp. manufactures one product with a standard direct labor cost of 2 hours at $6.00 per hour. During March, 500 units were produced using 1,050 hours at $6.10 per hour. The unfavorable direct labor efficiency variance is
   a. $100
   b. $105
   c. $300
   d. $305

2N89#25. The following information appeared in the accounting records of a retail store for the year ended December 31, 1988:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$300,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>140,000</td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
</tr>
<tr>
<td>January 1</td>
<td>70,000</td>
</tr>
<tr>
<td>December 31</td>
<td>100,000</td>
</tr>
<tr>
<td>Sales commissions</td>
<td>10,000</td>
</tr>
</tbody>
</table>

The gross margin was
   a. $190,000
   b. $180,000
   c. $160,000
   d. $150,000

2M87#22. Rail Co. sells 20,000 radios evenly throughout the year. The cost of carrying one unit in inventory for one year is $8, and the purchase order cost per order is $32. What is the economic order quantity?
   a. 625
   b. 400
   c. 283
   d. 200

2M87#26. The following standard costs pertain to a component part manufactured by Bor Co.:

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

*The items omitted can be found in other Content Specification Groups.
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:

\[ Q = 6000 + 5.25Z \]

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

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:

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 processed per year $600  
Standard variable cost of processing 1,500,000 papers $900,000  
Fixed costs per year $150,000  

The following information pertains to the 1,200,000 papers that were processed during 1986:

Total cost $915,000  
Labor cost $760,000  
Labor hours 190,000  

33. For 1986, Duo's labor rate variance would be

a. $40,000 unfavorable.  
b. $32,000 favorable.  
c. $10,000 unfavorable.  
d. $0.

*The item omitted can be found in other Content Specification Groups.
VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M90#46. The following information pertains to Pine City's general fund for 1989:

<table>
<thead>
<tr>
<th>Appropriations</th>
<th>$6,500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Other financing sources</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Other financing uses</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Revenues</td>
<td>8,000,000</td>
</tr>
</tbody>
</table>

After Pine's general fund accounts were closed at the end of 1989, the fund balance increased by
a. $3,000,000
b. $2,500,000
c. $1,500,000
d. $1,000,000

2M90#50. Harbor City's appropriations control account at December 31, 1989 had a balance of $7,000,000. When the budgetary accounts were closed at year-end, this $7,000,000 appropriations control balance should have
a. Been debited.
b. Been credited.
c. Remained open.
d. Appeared as a contra account.

2M90#51. The following revenues were among those reported by Ariba Township in 1989:

Net rental revenue (after depreciation) from a parking garage owned by Ariba $40,000
Interest earned on investments held for employees' retirement benefits 100,000
Property taxes 6,000,000

What amount of the foregoing revenues should be accounted for in Ariba's governmental-type funds?

a. $6,140,000
b. $6,100,000
c. $6,040,000
d. $6,000,000

2M90#54. The following information pertains to Cobb City:

- 1989 governmental fund revenues that became measurable and available in time to be used for payment of 1989 liabilities $16,000,000
- Revenues earned in 1987 and 1988 and included in the $16,000,000 indicated above 2,000,000
- Sales taxes collected by merchants in 1989 but not required to be remitted to Cobb until January 1990 3,000,000

For the year ended December 31, 1989, Cobb should recognize revenues of
a. $14,000,000
b. $16,000,000
c. $17,000,000
d. $19,000,000

2M90#55. Oro County's expenditures control account at December 31, 1989 had a balance of $9,000,000. When Oro's books were closed, this $9,000,000 expenditures control balance should have
a. Been debited.
b. Been credited.
c. Remained open.
d. Appeared as a contra account.

2M90#56. At December 31, 1989, Alto Township's committed appropriations that had not been expended in 1989 totaled $10,000. These appropriations do not lapse at year-end. Alto reports on a calendar-year basis. On its December 31, 1989 balance sheet, the $10,000 should be reported as
a. Vouchers payable — prior year.
b. Deferred expenditures.
c. Fund balance reserved for encumbrances.
d. Budgetary fund balance — reserved for encumbrances.

2M90#57. When Rolan County adopted its budget for the year ending June 30, 1990, $20,000,000 was recorded for estimated revenues control. Actual revenues for the year ended June 30, 1990 amounted to $17,000,000. In closing the budgetary accounts at June 30, 1990,

a. Revenues control should be debited for $3,000,000.
b. Estimated revenues control should be debited for $3,000,000.
c. Revenues control should be credited for $20,000,000.
d. Estimated revenues control should be credited for $20,000,000.

2M89

Items 21 through 26 are based on the following:

Cliff Township's fiscal year ends on July 31. Cliff uses encumbrance accounting. On October 2, 1988, an approved $5,000 purchase order was issued for supplies. Cliff received these supplies on November 2, 1988, and the $5,000 invoice was approved for payment by the general fund.

During the year ended July 31, 1989, Cliff received a state grant of $150,000 to finance the purchase of a senior citizens recreation bus, and an additional $15,000 grant to be used for bus operations during the year ended July 31, 1989. Only $125,000 of the capital grant was used during the year ended July 31, 1989 for the bus purchase, but the entire operating grant of $15,000 was disbursed during the year.
Cliff's governing body adopted its general fund budget for the year ending July 31, 1990, comprising estimated revenues of $50,000,000 and appropriations of $40,000,000. Cliff formally integrates its budget into the accounting records.

21. What accounts should Cliff debit and credit on October 2, 1988 to record the approved $5,000 purchase order?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Encumbrances control</td>
<td>Appropriations control</td>
</tr>
<tr>
<td>b. Appropriations control</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td>c. Encumbrances control</td>
<td>Budgetary fund balance — reserved for encumbrances</td>
</tr>
<tr>
<td>d. Budgetary fund balance — reserved for encumbrances</td>
<td>Encumbrances control</td>
</tr>
</tbody>
</table>

22. What accounts should Cliff debit and credit on November 2, 1988 upon receipt of the supplies and approval of the $5,000 invoice?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Budgetary fund balance — reserved for encumbrances Expenditures control</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td>b. Encumbrances control</td>
<td>Budgetary fund balance — reserved for encumbrances Appropriations control</td>
</tr>
<tr>
<td>c. Appropriations control Supplies inventory</td>
<td>Encumbrances control</td>
</tr>
<tr>
<td>d. Encumbrances control</td>
<td>Appropriations control</td>
</tr>
<tr>
<td>Expenditures control</td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>Appropriations control</td>
<td>Vouchers payable</td>
</tr>
<tr>
<td>Supplies control</td>
<td>Vouchers payable</td>
</tr>
</tbody>
</table>

23. The senior citizens recreation bus program is accounted for as part of Cliff's general fund. What amount should Cliff report as grant revenues for the year ended July 31, 1989 in connection with the state grants?

- a. $165,000
- b. $150,000
- c. $140,000
- d. $125,000

24. When Cliff records budgeted revenues, estimated revenues control should be

- a. Debit for $10,000,000.
- b. Credited for $10,000,000.
- c. Debit for $50,000,000.
- d. Credited for $50,000,000.

25. To record the $40,000,000 of budgeted appropriations, Cliff should

- a. Debit estimated expenditures control.
- b. Credit estimated expenditures control.
- c. Debit appropriations control.
- d. Credit appropriations control.

26. The $10,000,000 budgeted excess of revenues over appropriations should be

- b. Credited to budgetary fund balance—unreserved.
- c. Debit to estimated excess revenues control.
- d. Credited to estimated excess revenues control.

2M88

Items 44 through 50 are based on the following information:

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

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

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

45. Budgeted revenues would be recorded by a
   a. Debit to estimated revenues control, $10,000,000.  
   b. Debit to estimated revenues receivable, $10,000,000.  
   c. Credit to estimated revenues, $10,000,000.  
   d. Credit to other financing sources control, $10,000,000.

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

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

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Expenditures control</td>
<td>$1,500</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>$1,500</td>
</tr>
<tr>
<td>b. Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Expenditures control</td>
<td>1,500</td>
</tr>
<tr>
<td>c. Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Fund balance reserved</td>
<td>1,500</td>
</tr>
<tr>
<td>for encumbrances</td>
<td></td>
</tr>
<tr>
<td>d. Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Appropriations control</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>a. Encumbrances control</td>
<td>$1,500</td>
</tr>
<tr>
<td>Appropriations control</td>
<td>$1,500</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>1,500</td>
</tr>
<tr>
<td>b. Fund balance reserved for encumbrances</td>
<td>1,500</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Expenditures control</td>
<td>1,500</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>1,500</td>
</tr>
<tr>
<td>c. Appropriations control</td>
<td>1,500</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Expenditures control</td>
<td>1,500</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>1,500</td>
</tr>
<tr>
<td>d. Expenditures control</td>
<td>1,500</td>
</tr>
<tr>
<td>Encumbrances control</td>
<td>1,500</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>1,500</td>
</tr>
</tbody>
</table>

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>a. Salaries and wages expense</td>
<td>$200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>$200,000</td>
</tr>
<tr>
<td>b. Appropriations control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
<tr>
<td>c. Encumbrances control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
<tr>
<td>d. Expenditures control</td>
<td>200,000</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>200,000</td>
</tr>
</tbody>
</table>

B. Types of Funds and Fund Accounts

2N90#41. Maple Township issued the following bonds during the year ended June 30, 1990:

Bonds issued for the garbage collection enterprise fund that will service the debt $500,000
Revenue bonds to be repaid from admission fees collected by the Township zoo enterprise fund 350,000

What amount of these bonds should be accounted for in Maple's general long-term debt account group?
   a. $0
   b. $350,000
   c. $500,000
   d. $850,000

2N90#42. On December 31, 1989, Elm Village paid a contractor $4,500,000 for the total cost of a new Village Hall built in 1989 on Village-owned land. Financing for the capital project was provided by a $3,000,000 general obligation bond issue sold at face amount on December 31, 1989, with the remaining $1,500,000 transferred from the general fund. What account and amount should be reported in Elm's 1989 financial statements for the general fund?
   a. Other financing sources control $4,500,000.
   b. Expenditures control $4,500,000.
   c. Other financing sources control $3,000,000.
   d. Other financing uses control $1,500,000.

2N90#43. During 1989, Spruce City reported the following receipts from self-sustaining activities paid for by users of the services rendered:

Operation of water supply plant $5,000,000
Operation of bus system 900,000
Selected Questions

What amount should be accounted for in Spruce’s enterprise funds?

a. $0
b. $900,000
c. $5,000,000
d. $5,900,000

Lori Township received a gift of an ambulance having a market value of $180,000. What account in the general fixed assets account group should be debited for this $180,000 gift?

a. None (memorandum entry only).
b. Investment in general fixed assets from gifts.
c. Machinery and equipment.
d. General fund assets.

Through an internal service fund, Wood County operates a centralized data processing center to provide services to Wood’s other governmental units. In 1989, this internal service fund billed Wood’s parks and recreation fund $75,000 for data processing services. What account should Wood’s internal service fund credit to record this $75,000 billing to the parks and recreation fund?

a. Operating revenues control.
b. Interfund exchanges.
c. Intergovernmental transfers.
d. Data processing department expenses.

Kew City received a $15,000,000 federal grant to finance the construction of a center for rehabilitation of drug addicts. The proceeds of this grant should be accounted for in the

a. Special revenue funds.
b. General fund.
c. Capital projects funds.
d. Trust funds.

Lisa County issued $5,000,000 of general obligation bonds at 101 to finance a capital project. The $50,000 premium was to be used for payment of principal and interest. This transaction should be accounted for in the

a. Capital projects funds, debt service funds, and the general long-term debt account group.
b. Capital projects funds and debt service funds only.
c. Debt service funds and the general long-term debt account group only.
d. Debt service funds only.

In 1989, a state government collected income taxes of $8,000,000 for the benefit of one of its cities that imposes an income tax on its residents. The state remitted these collections periodically to the city. The state should account for the $8,000,000 in the

a. General fund.
b. Agency funds.
c. Internal service funds.
d. Special assessment funds.

Cliff Hospital, a voluntary institution, has a pure endowment fund, the income from which is required to be used for library acquisitions. State law and the donor are silent on the accounting treatment for investment gains and losses. In 1989, Cliff sold 1,000 shares of stock from the endowment fund’s investment portfolio. The carrying amount of these securities was $50,000. Net proceeds from the sale amounted to $120,000. This transaction should be recorded in the endowment fund as a debit to cash for $120,000 and as credits to

a. Endowment fund principal, $50,000 and endowment fund revenue, $70,000.
b. Endowment fund principal, $50,000 and due to general fund, $70,000.
c. Investments, $50,000 and endowment fund balance, $70,000.
d. Investments, $50,000 and endowment fund revenue, $70,000.

The following financial resources were among those received by Seco City during 1989:

For acquisition of major capital facilities $6,000,000
To create an expendable trust 2,000,000

With respect to the foregoing resources, what amount should be recorded in special revenue funds?

a. $0
b. $2,000,000
c. $6,000,000
d. $8,000,000

Items 1 through 6 are based on the following:

Rock County has acquired equipment through a non-cancelable lease-purchase agreement dated December 31, 1989. This agreement requires no down payment and the following minimum lease payments:

<table>
<thead>
<tr>
<th>December 31</th>
<th>Principal</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$50,000</td>
<td>$15,000</td>
<td>$65,000</td>
</tr>
<tr>
<td>1991</td>
<td>50,000</td>
<td>10,000</td>
<td>60,000</td>
</tr>
<tr>
<td>1992</td>
<td>50,000</td>
<td>5,000</td>
<td>55,000</td>
</tr>
</tbody>
</table>

1. What account should be debited for $150,000 in the general fund at inception of the lease if the equipment is a general fixed asset and Rock does not use a capital projects fund?

a. Other financing uses control.
b. Equipment.
c. Expenditures control.
d. Memorandum entry only.
2. What account should be credited for $150,000 in the general fixed assets account group at inception of the lease if the equipment is a general fixed asset?
   a. Fund balance from capital lease transactions.
   b. Other financing sources control — capital leases.
   c. Expenditures control — capital leases.
   d. Investment in general fixed assets — capital leases.

3. What journal entry is required for $150,000 in the general long-term debt account group at inception of the lease if the lease payments are to be financed with general government resources?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Expenditures control.</td>
<td>Other financing sources control.</td>
</tr>
<tr>
<td>b. Other financing uses control.</td>
<td>Expenditures control.</td>
</tr>
<tr>
<td>c. Amount to be provided for lease payments</td>
<td>Capital lease payable.</td>
</tr>
<tr>
<td>d. Capital lease payable.</td>
<td>Amount to be provided for lease payments.</td>
</tr>
</tbody>
</table>

4. If the lease payments are required to be made from a debt service fund, what account or accounts should be debited in the debt service fund for the December 31, 1990 lease payment of $65,000?
   a. Expenditures control $65,000
   b. Other financing sources control $50,000
   c. Amount to be provided for lease payments $50,000
   d. Expenditures control $50,000

5. If the equipment is used in enterprise fund operations and the lease payments are to be financed with enterprise fund revenues, what account should be debited for $150,000 in the enterprise fund at inception of the lease?
   a. Expenses control.
   b. Expenditures control.
   c. Other financing sources control.
   d. Equipment.

6. If the equipment is used in internal service fund operations and the lease payments are financed with internal service fund revenues, what account or accounts should be debited in the internal service fund for the December 31, 1990 lease payment of $65,000?
   a. Expenditures control $65,000
   b. Expenses control $65,000
   c. Capital lease payable $50,000
   d. Expenditures control $50,000

2M90

Items 7 and 8 are based on the following:

Elm City contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

<table>
<thead>
<tr>
<th>Contribution made</th>
<th>Actuarial requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount</strong></td>
<td><strong>Percent</strong></td>
</tr>
<tr>
<td>1989</td>
<td>$11,000</td>
</tr>
<tr>
<td>1988</td>
<td>5,000</td>
</tr>
<tr>
<td>1987</td>
<td>None</td>
</tr>
</tbody>
</table>

7. What account should be credited in the pension trust fund to record the 1989 employer contribution of $11,000?
   a. Revenues control.
   b. Other financing sources control.
   c. Due from special revenue fund.
   d. Pension benefit obligation.

8. To record the 1989 pension contribution of $11,000, what debit is required in the governmental-type fund used in connection with employer pension contributions?
   a. Other financing uses control.
   b. Expenditures control.
   c. Expenses control.
   d. Due to pension trust fund.

2M90#10. Grove Township issued $50,000 of bond anticipation notes at face amount in 1989 and placed the proceeds into its capital projects fund. All legal steps were taken to refinance the notes, but Grove was unable to consummate refinancing. In the capital projects fund, what account should be credited to record the $50,000 proceeds?
   a. Other financing sources control.
   b. Revenues control.
   c. Deferred revenues.
   d. Bond anticipation notes payable.
Selected Questions

2M90
Items 14 and 15 are based on the following:

In 1979, Community Helpers, a voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 1989. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 1989 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

14. In regard to the certificate of deposit, what should be reported in the endowment fund column of the 1989 statement of support, revenue, and expenses and changes in fund balances?
   a. Legacies and bequests, $100,000.
   b. Direct reduction in fund balance for transfer to current unrestricted fund, $100,000.
   c. Transfer to land, building, and equipment fund, $20,000.
   d. Revenues control, $100,000.

15. What should be reported in the current unrestricted funds column of the 1989 statement of support, revenue, and expenses and changes in fund balances?
   a. Investment income, $8,000.
   b. Direct reduction of fund balance for transfer to land, building, and equipment fund, $20,000.
   c. Direct addition to fund balance for transfer from endowment fund, $100,000.
   d. Public support, $108,000.

2M89#28. On December 31, 1988, Park Township paid a contractor $4,000,000 for the total cost of a new police building built in 1988. Financing was by means of a $3,000,000 general obligation bond issue sold at face amount on December 31, 1988, with the remaining $1,000,000 transferred from the general fund. What amount should Park record as revenues in the capital projects fund in connection with the bond issue proceeds and the transfer?
   a. $0
   b. $1,000,000
   c. $3,000,000
   d. $4,000,000

2M89#39. The following fund types used by Green Township had total assets at June 30, 1989 as follows:

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency funds</td>
<td>$300,000</td>
</tr>
<tr>
<td>Debt service funds</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Total fiduciary fund assets amount to
   a. $0
   b. $300,000
   c. $1,000,000
   d. $1,300,000

2N88
Items 41 and 42* are based on the following:

On December 31, 1987, Vane City paid a contractor $3,000,000 for the total cost of a new municipal annex built in 1987 on city-owned land. Financing was provided by a $2,000,000 general obligation bond issue sold at face amount on December 31, 1987, with the remaining $1,000,000 transferred from the general fund.

42. What accounts and amounts should be reported in Vane’s 1987 financial statements for the capital projects fund?
   a. Other financing sources control, $2,000,000; General long-term debt, $2,000,000.
   b. Revenues control, $2,000,000; Expenditures control, $2,000,000.
   c. Other financing sources control, $3,000,000; Expenditures control, $3,000,000.
   d. Revenues control, $3,000,000; Expenditures control, $3,000,000.

2N88#43. The following information for the year ended June 30, 1988 pertains to a proprietary fund established by Burwood Village in connection with Burwood's public parking facilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts from users of parking facilities</td>
<td>$400,000</td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
</tr>
<tr>
<td>Parking meters</td>
<td>$210,000</td>
</tr>
<tr>
<td>Salaries and other cash expenses</td>
<td>$90,000</td>
</tr>
<tr>
<td>Depreciation of parking meters</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

For the year ended June 30, 1988, this proprietary fund should report net income of
   a. $0
   b. $30,000
   c. $100,000
   d. $240,000

2N88#44. The following proceeds received by Grove City in 1987 are legally restricted to expenditure for specified purposes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donation by a benefactor mandated to an expendable trust fund to provide meals for the needy</td>
<td>$300,000</td>
</tr>
<tr>
<td>Sales taxes to finance the maintenance of tourist facilities in the shopping district</td>
<td>$900,000</td>
</tr>
</tbody>
</table>

What amount should be accounted for in Grove’s special revenue funds?
   a. $0
   b. $300,000
   c. $900,000
   d. $1,200,000

*The item omitted can be found in other Content Specification Groups.
2N88#45. In connection with Albury Township's long-term debt, the following cash accumulations are available to cover payment of principal and interest on bonds for financing of:

- Water treatment plant construction: $1,000,000
- General long-term obligations: 400,000

The amount of these cash accumulations that should be accounted for in Albury's debt service funds is:

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

2N88#46. During its fiscal year ended June 30, 1988, Lake County financed the following projects by special assessments:

- Capital improvements: $2,000,000
- Service-type projects: 800,000

For financial reporting purposes, what amount should appear in special assessment funds?

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

2N88#47. Hull City has established a separate internal service (self-insurance) fund to pay claims and judgments of all of Hull's funds. In 1987, payments to the insurer fund amounted to $500,000, while the actuarially determined amount was $400,000. The payments to the insurer fund should be accounted for as:

<table>
<thead>
<tr>
<th>An operating transfer of</th>
<th>A residual equity transfer of</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $100,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>c. $400,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>d. $500,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

2N88#48. The following fund types used by Cliff City had total assets at December 31, 1987, as follows:

- Special revenue funds: $100,000
- Agency funds: 150,000
- Trust funds: 200,000

Total fiduciary fund assets amounted to:

a. $200,000
b. $300,000
c. $350,000
d. $450,000

2N88#49. The following information pertains to a computer that Pine Township leased from Karl Supply Co. on July 1, 1988, for general township use:

- Karl's cost: $5,000
- Fair value at July 1, 1988: $5,000
- Estimated economic life: 5 years
- Fixed noncancelable term: 30 months
- Rental at beginning of each month: $135
- Guaranteed residual value: $2,000
- Present value of minimum lease payments at July 1, 1988, using Karl's implicit interest rate of 12.04%: $5,120

On July 1, 1988, what amount should Pine capitalize in its general fixed assets account group for this leased computer?

a. $0
b. $3,000
c. $5,000
d. $5,120

2N88#51. Lane Foundation received a nonexpendable endowment of $500,000 in 1986 from Gant Enterprises. The endowment assets were invested in publicly traded securities. Gant did not specify how gains and losses from disposals of endowment assets were to be treated. No restrictions were placed on the use of dividends received and interest earned on fund resources. In 1987, Lane realized gains of $50,000 on sales of fund investments, and received total interest and dividends of $40,000 on fund securities. The amount of these capital gains, interest, and dividends available for expenditure by Lane's unrestricted current fund is:

a. $0
b. $40,000
c. $50,000
d. $90,000

2N88#52. In 1987, the Board of Trustees of Burr Foundation designated $100,000 from its current funds for college scholarships. Also in 1987, the foundation received a bequest of $200,000 from an estate of a benefactor who specified that the bequest was to be used for hiring teachers to tutor handicapped students. What amount should be accounted for as current restricted funds?

a. $0
b. $100,000
c. $200,000
d. $300,000
**Selected Questions**

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

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

The amount that should be classified as fixed assets in Wood's general fund balance sheet at June 30, 1987 is:

a. $25,000  
b. $15,000  
c. $10,000  
d. $0

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

a. Fund balance — agency fund, $10,000.  
b. Fees earned — agency fund, $10,000.  
c. Due to Grove County general fund, $10,000.  
d. Revenues control, $10,000.

2N87#47. The following information pertains to Wood Township's long-term debt:

Cash accumulations to cover payment of principal and interest on

General long-term obligations $350,000  
Proprietary fund obligations 100,000

How much of these cash accumulations should be accounted for in Wood's debt service funds?

a. $0  
b. $100,000  
c. $350,000  
d. $450,000

2N87#48. In 1986, Menton City received $5,000,000 of bond proceeds to be used for capital projects. Of this amount, $1,000,000 was expended in 1986. Expenditures for the $4,000,000 balance were expected to be incurred in 1987. These bond proceeds should be recorded in capital projects funds for:

a. $5,000,000 in 1986.  
b. $5,000,000 in 1987.  
c. $1,000,000 in 1986 and $4,000,000 in 1987.  
d. $1,000,000 in 1986 and in the general fund for $4,000,000 in 1986.

2N87#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:

a. $0  
b. $300,000  
c. $400,000  
d. $700,000

2N87#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?

a. $1,400,000  
b. $900,000  
c. $500,000  
d. $0

2N87#54. Lake City operates a centralized data processing center through an internal service fund, to provide data processing services to Lake's other governmental units. In 1986, this internal service fund billed Lake's water and sewer fund $100,000 for data processing services. How should the internal service fund record this billing?

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>—</td>
</tr>
<tr>
<td>a. Memorandum entry only</td>
<td>—</td>
</tr>
<tr>
<td>b. Due from water and sewer fund</td>
<td>$100,000</td>
</tr>
<tr>
<td>Data processing department expenses</td>
<td>$100,000</td>
</tr>
<tr>
<td>c. Intergovernmental transfers Interfund exchanges</td>
<td>$100,000</td>
</tr>
<tr>
<td>d. Due from water and sewer fund</td>
<td>$100,000</td>
</tr>
<tr>
<td>Operating revenues control</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

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>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>240,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>240,000</td>
<td></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>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

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.

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

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

2N80 Items 58 through 60 are based on the following:

United Together, a labor union, had the following receipts and expenses for the year ended December 31, 1989:

**Receipts:**

- Per capita dues $680,000
- Initiation fees 90,000
- Sales of organizational supplies 60,000
- Nonexpendable gift restricted by donor for loan purposes for 10 years 30,000
- Nonexpendable gift restricted by donor for loan purposes in perpetuity 25,000

**Expenses:**

- Labor negotiations 500,000
- Fund-raising 100,000
- Membership development 50,000
- Administrative and general 200,000

**Additional information:**

The union's constitution provides that 10% of the per capita dues are designated for the Strike Insurance Fund to be distributed for strike relief at the discretion of the union's executive board.

58. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of revenue for both undesignated and designated funds?

a. $740,000
b. $762,000
c. $770,000
d. $830,000

59. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of program services?

a. $850,000
b. $600,000
c. $550,000
d. $500,000

60. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of capital additions?

a. $55,000
b. $30,000
c. $25,000
d. $0

*The item omitted can be found in other Content Specification Groups.
Selected Questions

2M90
**Item 9** is based on the following:

Elm City contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Percent</th>
<th>Amount</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>$11,000</td>
<td>26</td>
<td>$11,000</td>
<td>26</td>
</tr>
<tr>
<td>1988</td>
<td>5,000</td>
<td>12</td>
<td>10,000</td>
<td>24</td>
</tr>
<tr>
<td>1987</td>
<td>None</td>
<td>None</td>
<td>8,000</td>
<td>20</td>
</tr>
</tbody>
</table>

9. In the notes to Elm's 1989 financial statements, employer contributions expressed as percentages of annual covered payroll should be shown to the extent available for a minimum of
   a. 1 year.
   b. 2 years.
   c. 3 years.
   d. 12 years.

2M90
**Item 16** is based on the following:

In 1979, Community Helpers, a voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 1989. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 1989 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

16. What should be reported in the 1989 year-end current unrestricted funds balance sheet?
   a. Fund balance designated for preschool program, $28,000; Undesignated fund balance, $80,000.
   b. Fund balance designated for purchase of equipment, $20,000; Undesignated fund balance, $80,000.
   c. Fund balance designated for preschool program salaries, $8,000; Undesignated fund balance, $80,000.
   d. Undesignated fund balance, $72,000.

2M90
**Item 19** is based on the following:

Metro General is a municipally-owned and operated hospital and a component unit of Metro City. In 1989, the hospital received $7,000 in unrestricted gifts and $4,000 in unrestricted bequests. The hospital has $800,000 in long-term debt and $1,200,000 in fixed assets.

The hospital has transferred certain resources to a hospital guild. Substantially all of the guild's resources are held for the benefit of the hospital. The hospital controls the guild through contracts that provide it with the authority to direct the guild's activities, management, and policies. The hospital has also assigned certain of its functions to a hospital auxiliary, which operates primarily for the benefit of the hospital. The hospital does not have control over the auxiliary. The financial statements of the guild and the auxiliary are not consolidated with the hospital's financial statements. The guild and the auxiliary have total assets of $20,000 and $30,000, respectively.

Before the hospital's financial statements were combined with those of the city, the city's statements included data on one special revenue fund and one enterprise fund. The city's statements showed $100,000 in enterprise fund long-term debt, $500,000 in enterprise fund fixed assets, $1,000,000 in general long-term debt, and $6,000,000 in general fixed assets.

19. In the hospital's notes to financial statements, total assets of hospital-related organizations required to be disclosed amount to
   a. $0
   b. $20,000
   c. $30,000
   d. $50,000

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

2M90#11. In July 1988, Ross donated $200,000 cash to a church with the stipulation that the revenue generated from this gift be paid to Ross during Ross' lifetime. The conditions of this donation are that, after Ross dies, the principal may be used by the church for any purpose voted on by the church elders. The church received interest of $16,000 on the $200,000 for the year ended June 30, 1989, and the interest was remitted to Ross. In the church's June 30, 1989 annual financial statements.
   a. $200,000 should be reported as deferred support in the balance sheet.
   b. $184,000 should be reported under support and revenue in the activity statement.
   c. $16,000 should be reported under support and revenue in the activity statement.
   d. The gift and its terms should be disclosed only in notes to the financial statements.

2M90#12. Birdlovers, a community foundation, incurred $5,000 in management and general expenses during 1989. In Birdlovers' statement of revenue, expense, and changes in fund balance for the year ended December 31, 1989, the $5,000 should be reported as
   a. A contra account offsetting revenue and support.
   b. Part of program services.
   c. Part of supporting services.
   d. A direct reduction of fund balance.
2M90#13. Lema Fund, a voluntary welfare organization funded by contributions from the general public, received unrestricted pledges of $200,000 during 1989. It was estimated that 10% of these pledges would be uncollectible. By the end of 1989, $130,000 of the pledges had been collected. It was expected that $50,000 more would be collected in 1990 and that the balance of $20,000 would be written off as uncollectible. What amount should Lema include under public support in 1989 for net contributions?
   a. $200,000
   b. $180,000
   c. $150,000
   d. $130,000

2M90

Items 17 through 20* are based on the following:

Metro General is a municipally-owned and operated hospital and a component unit of Metro City. In 1989, the hospital received $7,000 in unrestricted gifts and $4,000 in unrestricted bequests. The hospital has $800,000 in long-term debt and $1,200,000 in fixed assets.

The hospital has transferred certain resources to a hospital guild. Substantially all of the guild’s resources are held for the benefit of the hospital. The hospital controls the guild through contracts that provide it with the authority to direct the guild’s activities, management, and policies. The hospital has also assigned certain of its functions to a hospital auxiliary, which operates primarily for the benefit of the hospital. The hospital does not have control over the auxiliary. The financial statements of the guild and the auxiliary are not consolidated with the hospital’s financial statements. The guild and the auxiliary have total assets of $20,000 and $30,000, respectively.

Before the hospital’s financial statements were combined with those of the city, the city’s statements included data on one special revenue fund and one enterprise fund. The city’s statements showed $100,000 in enterprise fund long-term debt, $500,000 in enterprise fund fixed assets, $1,000,000 in general long-term debt, and $6,000,000 in general fixed assets.

17. What account or accounts should be credited for the $7,000 of unrestricted gifts and the $4,000 of unrestricted bequests?
   a. Operating revenue $11,000
   b. Nonoperating revenue $11,000
   c. Operating revenue $7,000
      Nonoperating revenue 4,000
   d. Nonoperating revenue $7,000
      Operating revenue 4,000

18. The hospital’s long-term debt should be reported in the city’s combined balance sheet as
   a. Part of $900,000 enterprise fund type long-term debt in the enterprise fund type column.
   b. An $800,000 contra amount against fixed assets.
   c. Part of the $1,800,000 general long-term debt account group.
   d. A separate “discrete presentation” of $800,000 in the hospital column.

20. The hospital’s fixed assets should be reported in the city’s combined balance sheet as
   a. Hospital fixed assets of $1,200,000 in a separate “discrete presentation” hospital column.
   b. Special revenue fund type fixed assets of $1,200,000 in the general fixed assets account group column.
   c. Part of $1,700,000 enterprise fund type fixed assets in the enterprise fund type column.
   d. Part of $7,200,000 general fixed assets in the general fixed assets account group.

2M89

Items 29 through 31 are based on the following information pertaining to Lori Hospital for the year ended May 31, 1989:

In March 1989, a $300,000 unrestricted bequest and a $500,000 pure endowment grant were received. In April 1989, a bank notified Lori that the bank received $10,000 to be held in permanent trust by the bank. Lori is to receive the income from this donation.

29. Lori should record the $300,000 unrestricted bequest as
   a. Nonoperating revenue.
   b. Other operating revenue.
   c. A direct credit to the fund balance.
   d. A credit to operating expenses.

30. The $500,000 pure endowment grant
   a. May be expended by the governing board only to the extent of the principal since the income from this fund must be accumulated.
   b. Should be reported as nonoperating revenue when the full amount of principal is expended.
   c. Should be recorded as a memorandum entry only.
   d. Should be accounted for as restricted funds upon receipt.

31. The $10,000 donation being held by the bank in permanent trust should be
   a. Recorded in Lori’s restricted endowment fund.
   b. Recorded by Lori as nonoperating revenue.
   c. Recorded by Lori as other operating revenue.
   d. Disclosed in notes to Lori’s financial statements.

*The item omitted can be found in other Content Specification Groups.
2M89

Items 32 through 34* are based on the following information pertaining to Cabal University as of June 30, 1989 and for the year then ended:

Unrestricted current funds comprised $7,500,000 of assets and $4,500,000 of liabilities (including deferred revenues of $150,000). Among the receipts recorded during the year were unrestricted gifts of $550,000 and restricted grants totaling $330,000, of which $220,000 was expended during the year for current operations and $110,000 remained unexpended at the close of the year.

Volunteers from the surrounding communities regularly contribute their services to Cabal and are paid nominal amounts to cover their travel costs. During the year, the total amount paid to these volunteers aggregated $18,000. The gross value of services performed by them, determined by reference to equivalent wages available in that area for similar services, amounted to $200,000.

32. At June 30, 1989, the fund balance of Cabal’s unrestricted current funds was
   a. $7,500,000
   b. $3,150,000
   c. $3,000,000
   d. $2,850,000

33. For the year ended June 30, 1989, what amount should be included in Cabal’s current funds revenues for the unrestricted gifts and restricted grants?
   a. $550,000
   b. $660,000
   c. $770,000
   d. $880,000

2M89

Items 36 through 38 are based on the following information pertaining to Rega Foundation, a voluntary welfare organization funded by contributions from the general public:

During 1988, unrestricted pledges of $600,000 were received, of which it was estimated that $72,000 would be uncollectible. By the end of 1988, $480,000 of the pledges had been collected, and it was expected that an additional $48,000 of these pledges would be collected in 1989, with the balance to be written off as uncollectible. Donors did not specify any periods during which the donations were to be used.

Also during 1988, Rega sold a computer for $18,000. Its cost was $21,000 and its book value was $15,000. Rega made the correct entry to record the gain on sale.

36. What amount should Rega include under public support in 1988 for net contributions?
   a. $480,000
   b. $528,000
   c. $531,000
   d. $600,000

37. In addition to the entry recording the gain on sale of the computer, the other accounts that Rega should debit and credit in connection with this sale are

   Debit                                      Credit
   a. Current unrestricted funds              Fund balance—unde designated
   b. Excess revenues control                  Sale of equipment
   c. Fund balance—unexpended                 Fund balance—ex expended
   d. Fund balance—unexpended                 Fund balance—un expended

38. The amount that should be debited and credited for the additional entry in connection with the sale of the computer is
   a. $3,000
   b. $15,000
   c. $18,000
   d. $21,000

2N88#53. The following information pertains to interest received by Beech University from endowment fund investments for the year ended June 30, 1988:

<table>
<thead>
<tr>
<th>Received</th>
<th>Expended for current operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted</td>
<td>$300,000</td>
</tr>
<tr>
<td>Restricted</td>
<td>500,000</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

2N88#54. On July 31, 1988, Sabio College showed the following amounts to be used for

- Renewal and replacement of college properties $200,000
- Retirement of indebtedness on college properties 300,000
- Purchase of physical properties for college purposes, but unexpended at 7/31/88 400,000

What total amount should be included in Sabio’s plant funds at July 31, 1988?
   a. $900,000
   b. $600,000
   c. $400,000
   d. $200,000

*The item omitted can be found in other Content Specification Groups.


**Accounting Practice**

**2N88#56.** Under Cura Hospital’s established rate structure, patient service revenues of $9,000,000 would have been earned for the year ended December 31, 1987. However, only $6,750,000 was collected because of charity allowances of $1,500,000 and discounts of $750,000 to third-party payors. For the year ended December 31, 1987, what amount should Cura record as patient service revenues?

- a. $6,750,000
- b. $7,500,000
- c. $8,250,000
- d. $9,000,000

**2N88#57.** An organization of high school seniors performs services for patients at Leer Hospital. These students are volunteers and perform services that the hospital would not otherwise provide, such as wheeling patients in the park and reading to patients. Leer has no employer-employee relationship with these volunteers, who donated 5,000 hours of service to Leer in 1987. At the minimum wage rate, these services would amount to $18,750, while it is estimated that the fair value of these services was $25,000. In Leer’s 1987 statement of revenues and expenses, what amount should be reported as nonoperating revenue?

- a. $25,000
- b. $18,750
- c. $6,250
- d. $0

**2N88#58.** In June 1988, Park Hospital purchased medicines from Jove Pharmaceutical Co. at a cost of $2,000. However, Jove notified Park that the invoice was being canceled, and that the medicines were being donated to Park. Park should record this donation of medicines as

- a. A memorandum entry only.
- b. Other operating revenue of $2,000.
- c. A $2,000 credit to operating expenses.
- d. A $2,000 credit to nonoperating expenses.

**2N88#59.** In 1987, a nonprofit trade association enrolled five new member companies, each of which was obligated to pay nonrefundable initiation fees of $1,000. These fees were receivable by the association in 1987. Three of the new members paid the initiation fees in 1987, and the other two new members paid their initiation fees in 1988. Annual dues (excluding initiation fees) received by the association from all of its members have always covered the organization’s costs of services provided to its members. It can be reasonably expected that future dues will cover all costs of the organization’s future services to members. Average membership duration is 10 years because of mergers, attrition, and economic factors. What amount of initiation fees from these five new members should the association recognize as revenue in 1987?

- a. $5,000
- b. $3,000
- c. $500
- d. $0

**2N88#60.** On January 2, 1987, a nonprofit botanical society received a gift of an exhaustible fixed asset with an estimated useful life of 10 years and no salvage value. The donor’s cost of this asset was $20,000, and its fair market value at the date of the gift was $30,000. What amount of depreciation of this asset should the society recognize in its 1987 financial statements?

- a. $3,000
- b. $2,500
- c. $2,000
- d. $0

**2N88#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>$100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

**2N88#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.

**2N88#53.** Cedar Hospital has a marketable equity securities portfolio that is appropriately included in non-current 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.

**2N88#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

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Selected Questions

What amount should be included as part of unrestricted funds?

a. $12,000,000  
b. $10,000,000  
c. $ 2,000,000  
d. $0

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

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

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

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

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

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

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

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

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

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

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

- Restricted gifts received
  - Expended $100,000
  - Not expended 300,000
- Unrestricted gifts received
  - Expended 600,000
  - Not expended 75,000

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

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

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

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

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

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

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 group?

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 amounts to cover their commuting costs. During 1986, the total amount paid to these volunteers aggregated $12,000. The gross value of services performed by them, determined by reference to lay-equivalent salaries, amounted to $300,000. What amount should Park record as expenditures in 1986 for these volunteers' services?

a. $312,000  
b. $300,000  
c. $ 12,000  
d. $0
Accounting Practice

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>$3,000,000</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>$200,000</td>
</tr>
<tr>
<td>(expended for current</td>
<td></td>
</tr>
<tr>
<td>operating purposes)</td>
<td></td>
</tr>
<tr>
<td>Restricted current funds</td>
<td>$100,000</td>
</tr>
<tr>
<td>(not yet expended)</td>
<td></td>
</tr>
</tbody>
</table>

The amount that should be included in current funds revenues is

a. $800,000
b. $700,000
c. $600,000
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 if

a. Either $8,000,000 or $7,000,000, at the option of the hospital.
b. $8,000,000
c. $7,000,000
d. $7,500,000

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:

<table>
<thead>
<tr>
<th>Sales price</th>
<th>$12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>14,000</td>
</tr>
<tr>
<td>Carrying amount</td>
<td>10,000</td>
</tr>
</tbody>
</table>

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

57. The additional entry that Nous should record in connection with this sale is

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fund balance —</td>
<td>Fund balance —</td>
</tr>
<tr>
<td>expended</td>
<td>unexpended</td>
</tr>
<tr>
<td>b. Fund balance —</td>
<td>Fund balance —</td>
</tr>
<tr>
<td>unexpended</td>
<td>expended</td>
</tr>
<tr>
<td>c. Excess revenues control</td>
<td>Sale of equipment</td>
</tr>
<tr>
<td>d. Current unrestricted</td>
<td>Fund balance —</td>
</tr>
<tr>
<td>funds</td>
<td>undesignated</td>
</tr>
</tbody>
</table>

*The item omitted can be found in other Content Specification Groups.
Selected Questions

2M87#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

2M87#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.

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2M91#21. For a cash basis taxpayer, gain or loss on a year-end sale of listed stock arises on the
a. Trade date.
b. Settlement date.
c. Date of receipt of cash proceeds.
d. Date of delivery of stock certificate.

2M91#22. Cobb, an unmarried individual, had an adjusted gross income of $200,000 in 1990 before any IRA deduction, taxable social security benefits, or passive activity losses. Cobb incurred a loss of $30,000 in 1990 from rental real estate in which he actively participated. What amount of loss attributable to this rental real estate can be used in 1990 as an offset against income from nonpassive sources?

a. $0
b. $12,500
c. $25,000
d. $30,000

2M91#23. In a “like-kind” exchange of an investment asset for a similar asset that will also be held as an investment, no taxable gain or loss will be recognized on the transaction if both assets consist of
a. Convertible debentures.
b. Convertible preferred stock.
c. Partnership interests.
d. Rental real estate located in different states.

2M91#24. Lee, an attorney, uses the cash receipts and disbursements method of reporting. In 1990, a client gave Lee 500 shares of a listed corporation’s stock in full satisfaction of a $10,000 legal fee the client owed to Lee. This stock had a fair market value of $8,000 on the date it was given to Lee. The client’s basis for this stock was $6,000. Lee sold the stock for cash in January 1991. In Lee’s 1990 income tax return, what amount of income should be reported in connection with the receipt of the stock?

a. $10,000
b. $8,000
c. $6,000
d. $0

2M91#25. Clark bought Series EE U.S. Savings Bonds after 1989. Redemption proceeds will be used for payment of college tuition for Clark’s dependent child. One of the conditions that must be met for tax exemption of accumulated interest on these bonds is that the
a. Purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).
b. Bonds must be bought by a parent (or both parents) and put in the name of the dependent child.
c. Bonds must be bought by the owner of the bonds before the owner reaches the age of 24.
d. Bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

2M90#25. Ed and Ann Ross were divorced in January 1989. In accordance with the divorce decree, Ed transferred the title in their home to Ann in 1989. The home, which had a fair market value of $150,000, was subject to a $50,000 mortgage that had 20 more years to run. Monthly mortgage payments amount to $1,000. Under the terms of settlement, Ed is obligated to make the mortgage payments on the home for the full remaining 20-year term of the indebtedness, regardless of how long Ann lives. Ed made 12 mortgage payments in 1989. What amount is taxable as alimony in Ann’s 1989 return?

a. $0
b. $12,000
c. $100,000
d. $112,000

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Accounting Practice

2N90#26. Dahl Corp. was organized and commenced operations in 1930. At December 31, 1989, Dahl had accumulated earnings and profits of $9,000 before dividend declaration and distribution. On December 31, 1989, Dahl distributed cash of $9,000 and a vacant parcel of land to Green, Dahl’s only stockholder. At the date of distribution, the land had a basis of $5,000 and a fair market value of $40,000. What was Green’s taxable dividend income in 1989 from these distributions?
   a. $ 9,000
   b. $14,000
   c. $44,000
   d. $49,000

2N90#27. Don Wolf became a general partner in Gata Associates on January 1, 1989 with a 5% interest in Gata’s profits, losses, and capital. Gata is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 1989, Gata had an operating loss of $100,000. In addition, Gata earned interest of $20,000 on a temporary investment. Gata has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf’s passive loss for 1989 is
   a. $0
   b. $4,000
   c. $5,000
   d. $6,000

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts’ cash receipts during 1988 were the following:
$1,000 dividends from taxable domestic corporations on stocks held in Sam’s name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had no other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts’ cash expenditures during 1988 were the following:
$2,000 transportation expenses required under the terms of Sam’s employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

44. What was the taxable amount of dividends on Hoyts’ 1988 return?
   a. $1,000
   b. $900
   c. $800
   d. $700

45. What was the allowable amount of long-term capital loss that the Hoyts could offset against ordinary income on their 1988 return?
   a. $0
   b. $2,500
   c. $3,000
   d. $5,000

2M89#54. With regard to the passive loss rules involving rental real estate activities, which one of the following statements is correct?
   a. The term “passive activity” includes any rental activity without regard to whether or not the taxpayer materially participates in the activity.
   b. Gross investment income from interest and dividends not derived in the ordinary course of a trade or business is treated as passive activity income that can be offset by passive rental activity losses when the “active participation” requirement is not met.
   c. Passive rental activity losses may be deducted only against passive income, but passive rental activity credits may be used against tax attributable to nonpassive activities.
   d. The passive activity rules do not apply to taxpayers whose adjusted gross income is $300,000 or less.

2N88#2. Smith, a retired corporate executive, earned consulting fees of $8,000 and director’s fees of $2,000 in 1987. Smith’s gross income from self-employment in 1987 was
   a. $0
   b. $2,000
   c. $8,000
   d. $10,000

*The items omitted can be found in other Content Specification Groups.
Selected Questions

2N88#3. Pierre, a headwaiter, received tips totaling $2,000 in December 1987. On January 5, 1988, Pierre reported this tip income to his employer in the required written statement. At what amount, and in which year, should this tip income be included in Pierre’s gross income?

a. $2,000 in 1987.
b. $2,000 in 1988.
c. $1,000 in 1987, and $1,000 in 1988.
d. $167 in 1987, and $1,833 in 1988.

2N88#5. If an individual taxpayer’s passive losses and credits relating to rental real estate activities cannot be used in the current year, then they may be carried
a. Back three years, but they cannot be carried forward.
b. Forward up to a maximum period of 15 years, but they cannot be carried back.
c. Back three years or forward up to 15 years, at the taxpayer’s election.
d. Forward indefinitely or until the property is disposed of in a taxable transaction.

2N88#6. In 1987, Ben Loy and his wife, Ann, received dividends of $500 and $25, respectively, from taxable domestic corporations. What amount of these dividends could be excluded from the Loys’ taxable income on their 1987 joint return?

a. $0
b. $125
c. $200
d. $225

2N88#7. With regard to the alimony deduction in connection with a 1988 divorce, which one of the following statements is correct?

a. Alimony is deductible by the payor spouse, and includible by the payee spouse, to the extent that payment is contingent on the status of the divorced couple’s children.
b. The divorced couple may be members of the same household at the time alimony is paid, provided that the persons do not live as husband and wife.
c. Alimony payments must terminate on the death of the payee spouse.
d. Alimony may be paid either in cash or in property.

2N88#8. A 1988 capital loss incurred by a married couple filing a joint return
a. Will be allowed only to the extent of capital gains.
b. Will be allowed to the extent of capital gains, plus up to $3,000 of ordinary income.
c. May be carried forward up to a maximum of five years.
d. Is not an allowable loss.

2N88#9. In 1988, Joan accepted and received a $10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award. What amount should Joan include in her 1988 adjusted gross income in connection with this award?

a. $0
b. $4,000
c. $5,000
d. $10,000

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

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

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

a. $0
b. $2,000
c. $4,600
d. $5,000

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

a. $2,800
b. $3,500
c. $4,200
d. $7,000

2M88#4. For a married couple filing a 1987 joint return, the excess of net long-term capital loss over net short-term capital gain is

a. Reduced by 50% before being deducted from ordinary income.
b. Limited to a maximum deduction of $3,000 from ordinary income.
c. Allowed as a carryover against future capital gains up to a maximum period of five years.
d. Not deductible from ordinary income.

2M88#5. Ali 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

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Accounting Practice

2M88#6. During 1987, Ruth Loy received interest income as follows:

- On U.S. Treasury certificates: $3,000
- On refund of 1985 federal income tax: $200

The total amount of interest subject to tax in Ruth's 1987 return is:
- a. $0
- b. $200
- c. $3,000
- d. $3,200

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

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

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

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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

Benefit Life Insurance Co., on
   Gail’s life insurance policy
   (Total dividends received have
   not yet exceeded accumulated
   premiums paid) $100
Safe National Bank, on
   bank’s common stock 300
Roe Mfg. Corp., a Delaware
   corporation, on preferred stock 500

What amount of dividend income should Gail report in her 1987 income tax return?
   a. $900
   b. $800
   c. $500
   d. $300

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

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2N89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

   Sam — age 72; normal vision.
   Ann — age 67; legally blind.

   Adjusted gross income — $34,000.

   The Hoyts itemized their deductions.

Among the Hoyts’ cash receipts during 1988 were the following:
   a. $1,000 dividends from taxable domestic corporations on stocks held in Sam’s name.
   b. $4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had no other capital gains or losses in the current or prior years.
   c. $6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts’ cash expenditures during 1988 were the following:
   a. $2,000 transportation expenses required under the terms of Sam’s employment contract were paid by Sam, an outside salesman. No reimbursement was received.
   b. $2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
   c. $800 appraisal fee to determine amount of fire loss.
   d. $3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
   e. $100 contribution to a recognized political party.

46. What portion of the $6,000 installment on the life insurance policy is excludible from 1988 gross income in arriving at Hoyts’ adjusted gross income?
   a. $0
   b. $1,000
   c. $5,000
   d. $6,000

2N88#10. Which one of the following types of allowable deductions can be claimed as a deduction in arriving at an individual’s 1988 adjusted gross income?
   a. Unreimbursed business expenses of an outside salesman-employee.
   b. Personal casualty losses.
   c. Charitable contributions.
   d. Alimony payments.

2N88#11. Sol and Julia Crane are married, and filed a joint return for 1987. Sol earned a salary of $80,000 in 1987 from his job at Troy Corp., where Sol is covered by his employer’s pension plan. In addition, Sol and Julia earned interest of $3,000 in 1987 on their joint savings account. Julia is not employed, and the couple had no other income. On January 15, 1988, Sol contributed $2,000 to an IRA for himself, and $250 to an IRA for his spouse. The allowable IRA deduction in the Cranes’ 1987 joint return is
   a. $0
   b. $ 250
   c. $2,000
   d. $2,250

*The items omitted can be found in other Content Specification Groups.
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

2M87#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.

C. Gain or Loss on Property Transactions

2N90#28. Joe Hall owns a limousine for use in his personal service business of transporting passengers to airports. The limousine’s adjusted basis is $40,000. In addition, Hall owns his personal residence and furnishings, that together cost him $280,000. Hall’s capital assets amount to
   a. $320,000
   b. $280,000
   c. $40,000
   d. $0

2N90#29. Fred Berk bought a plot of land with a cash payment of $40,000 and a purchase money mortgage
   of $50,000. In addition, Berk paid $200 for a title insurance policy. Berk’s basis in this land is
   a. $40,000
   b. $40,200
   c. $90,000
   d. $90,200

2N90#30. In 1989, Joan Reed exchanged commercial real estate that she owned for other commercial real estate plus cash of $50,000. The following additional information pertains to this transaction:

   Property given up by Reed
   Fair market value $500,000
   Adjusted basis 300,000

   Property received by Reed
   Fair market value 450,000

   What amount of gain should be recognized in Reed’s 1989 income tax return?
   a. $200,000
   b. $100,000
   c. $50,000
   d. $0

2N89#41. In 1989, Ruth Lee sold a painting for $25,000 that she had bought for her personal use in 1979 at a cost of $10,000. In her 1989 return, Lee should treat the sale of the painting as a transaction resulting in
   a. Ordinary income.
   b. Long-term capital gain.
   c. Section 1231 gain.
   d. No taxable gain.

2M89#42. The following information pertains to the sale of Al Oran’s principal residence:

   Date of sale May 1989
   Date of purchase May 1979
   Net sales price $260,000
   Adjusted basis $70,000

   In June 1989, Oran (age 70) bought a smaller residence for $90,000. Oran elected to avail himself of the exclusion of realized gain available to taxpayers age 55 and over. What amount of gain should Oran recognize in 1989 on the sale of his residence?
   a. $45,000
   b. $65,000
   c. $70,000
   d. $90,000

2M89#52. On June 1, 1988, Ben Rork sold 500 shares of Kul Corp. stock. Rork had received this stock on May 1, 1988 as a bequest from the estate of his uncle,
Selected Questions

who died on March 1, 1988. Rork's basis was determined by reference to the stock's fair market value on March 1, 1988. Rork's holding period for this stock was
a. Short-term.
b. Long-term.
c. Short-term if sold at a gain; long-term if sold at a loss.
d. Long-term if sold at a gain; short-term if sold at a loss.

2M91#29. An individual's losses on transactions entered into for personal purposes are deductible only if
a. The losses qualify as casualty or theft losses.
b. The losses can be characterized as hobby losses.
c. The losses do not exceed $3,000 ($6,000 on a joint return).
d. No part of the transactions was entered into for profit.

2M91#30. Ruth and Mark Cline are married and will file a joint 1991 income tax return. Among their expenditures during 1991 were the following discretionary costs that they incurred for the sole purpose of improving their physical appearance and self-esteem:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Face lift for Ruth, performed by a</td>
<td>$5,000</td>
</tr>
<tr>
<td>licensed surgeon</td>
<td></td>
</tr>
<tr>
<td>Hair transplant for Mark, performed</td>
<td>$3,600</td>
</tr>
<tr>
<td>by a licensed surgeon</td>
<td></td>
</tr>
</tbody>
</table>

Disregarding the adjusted gross income percentage threshold, what total amount of the aforementioned doctors' bills may be claimed by the Clines in their 1991 return as qualifying medical expenses?

a. $0
b. $3,600
c. $5,000
d. $8,600

2M91#31. During 1990, Scott charged $4,000 on his credit card for his dependent son's medical expenses. Payment to the credit card company had not been made by the time Scott filed his income tax return in 1991. However, in 1990, Scott paid a physician $2,800 for the medical expenses of his wife, who died in 1989. Disregarding the adjusted gross income percentage threshold, what amount could Scott claim in his 1990 income tax return for medical expenses?

a. $0
b. $2,800
c. $4,000
d. $6,800

2M91#32. Which one of the following types of itemized deductions is included in the category of unreimbursed expenses deductible only if the aggregate of such expenses exceeds 2% of the taxpayer's adjusted gross income?

a. Interest expense.
b. Medical expenses.
c. Employee moving expenses.
d. Tax return preparation fees.
2N90#31. Marc Clay was unemployed for the entire year 1988. In January 1989, Clay obtained full-time employment 40 miles away from the city where he had resided during the ten years preceding 1989. Clay kept his new job for the entire year 1989. In January 1989, Clay paid direct moving expenses of $300 in relocating to his new city of residence, but he received no reimbursement for these expenses. In his 1989 income tax return, Clay’s direct moving expenses are
a. Not deductible.
b. Fully deductible only if Clay itemizes his deductions.
c. Fully deductible from gross income in arriving at adjusted gross income.
d. Deductible subject to a 2% threshold if Clay itemizes his deductions.

2N90#32. In 1989, Smith paid $6,000 to the tax collector of Wek City for realty taxes on a two-family house owned by Smith’s mother. Of this amount, $2,800 covered back taxes for 1988, and $3,200 covered 1989 taxes. Smith resides on the second floor of the house, and his mother resides on the first floor. In Smith’s itemized deductions on his 1989 return, what amount was Smith entitled to claim for realty taxes?
   a. $6,000
   b. $3,200
   c. $3,000
   d. $0

2N90#33. Which one of the following expenditures qualifies as a deductible medical expense for tax purposes?
   a. Vitamins for general health not prescribed by a physician.
   b. Health club dues.
   c. Transportation to physician’s office for required medical care.
   d. Mandatory employment taxes for basic coverage under Medicare A.

2N90#34. Which one of the following statements is correct with regard to an individual taxpayer who has elected to amortize the premium on a bond that yields taxable interest?
   a. The amortization is treated as an itemized deduction.
   b. The amortization is not treated as a reduction of taxable income.
   c. The bond’s basis is reduced by the amortization.
   d. The bond’s basis is increased by the amortization.

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:
   Sam — age 72; normal vision.
   Ann — age 67; legally blind.
   Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts’ cash receipts during 1988 were the following:
   $1,000 dividends from taxable domestic corporations on stocks held in Sam’s name.
   $4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had no other capital gains or losses in the current or prior years.
   $6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts’ cash expenditures during 1988 were the following:
   $2,000 transportation expenses required under the terms of Sam’s employment contract were paid by Sam, an outside salesman. No reimbursement was received.
   $2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
   $800 appraisal fee to determine amount of fire loss.
   $3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
   $100 contribution to a recognized political party.

48. What amount of fire loss were the Hoyts entitled to deduct as an itemized deduction on their 1988 return?
   a. $5,000
   b. $2,500
   c. $1,600
   d. $1,500

49. What total amount was deductible for taxes on the Hoyts' 1988 return?
   a. $4,300
   b. $3,900
   c. $3,400
   d. $3,000

50. The unreimbursed employee’s transportation expenses paid by Sam in 1988 were
   a. Deductible from gross income in arriving at adjusted gross income.
   b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
   c. Fully deductible as an itemized deduction.
   d. Not deductible.

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*The items omitted can be found in other Content Specification Groups.
51. The appraisal fee to determine the amount of the Hoyts’ fire loss was
   a. Deductible from gross income in arriving at adjusted gross income.
   b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
   c. Deductible after reducing the amount by $100.
   d. Not deductible.

2M88#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

2M88#15. The following information pertains to Cole's personal residence, which sustained casualty fire damage in 1987:

   Adjusted basis $150,000
   Fair market value
     immediately before the fire 200,000
   Fair market value
     immediately after the fire 180,000
   Fire damage repairs paid for
     by Cole in 1987 10,000

   The house was uninsured. Before consideration of any "floor" or other limitation on tax deductibility, the amount of this 1987 casualty loss was
   a. $30,000
   b. $20,000
   c. $10,000
   d. $0

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

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

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

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

E. Filing Status and Exemptions

2M91#34. A husband and wife can file a joint return even if
   a. The spouses have different tax years, provided that both spouses are alive at the end of the year.
   b. The spouses have different accounting methods.
   c. Either spouse was a nonresident alien at any time during the tax year, provided that at least one spouse makes the proper election.
   d. They were divorced before the end of the tax year.

2N9O#24. Al and Mary Lew are married and filed a joint 1989 income tax return in which they validly claimed the $2,000 personal exemption for their dependent 17-year old daughter, Doris. Since Doris earned $5,400 in 1989 from a part-time job at the college she attended full-time, Doris was also required to file a 1989 income tax return. What amount was Doris entitled to claim as a personal exemption in her 1989 individual income tax return?
   a. $0
   b. $1,000
   c. $2,000
   d. $3,000

2M69

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

*The items omitted can be found in other Content Specification Groups.  

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Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts’ cash receipts during 1988 were the following:
$1,000 dividends from taxable domestic corporations on stocks held in Sam’s name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had no other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts’ cash expenditures during 1988 were the following:
$2,000 transportation expenses required under the terms of Sam’s employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

43. How many personal exemptions were the Hoyts entitled to claim on their 1988 return?
   a. 2
   b. 3
   c. 4
   d. 5

2N88#16. Emil Gow’s wife died in 1985. Emil did not remarry, and he continued to maintain a home for himself and his dependent infant child during 1986 and 1987, providing full support for himself and his child during these years. For 1985, Emil properly filed a joint return. For 1987, Emil’s filing status is
   a. Single.
   b. Head of household.
   c. Qualifying widower with dependent child.
   d. Married filing joint return.

2N88#11. Ben and Doris Carr are married and filed a joint 1987 return. Ben is 72 and blind. Doris is 70 and has normal vision. How many personal exemptions may the Carrs claim on their 1987 return?
   a. 2
   b. 3
   c. 4
   d. 5

2N87#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.

F. Tax Computations and Credits

2M91#33. An employee who has had social security tax withheld in an amount greater than the maximum for a particular year, may claim
   a. Such excess as either a credit or an itemized deduction, at the election of the employee, if that excess resulted from correct withholding by two or more employers.
   b. Reimbursement of such excess from his employers, if that excess resulted from correct withholding by two or more employers.
   c. The excess as a credit against income tax, if that excess resulted from correct withholding by two or more employers.
   d. The excess as a credit against income tax, if that excess was withheld by one employer.

2N90#23. Which one of the following statements is correct with regard to the earned income credit?
   a. The credit is available only to those individuals whose earned income is equal to adjusted gross income.
   b. For purposes of the earned income test, “earned income” includes workers’ compensation benefits.
   c. The credit can result in a refund even if the individual had no tax withheld from wages.
   d. The credit is available to married couples who are childless.

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann

*The items omitted can be found in other Content Specification Groups.
Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts’ cash receipts during 1988 were the following:
$1,000 dividends from taxable domestic corporations on stocks held in Sam’s name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had no other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts’ cash expenditures during 1988 were the following:
$2,000 transportation expenses required under the terms of Sam’s employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

47. What amount of the $100 political contribution were the Hoyts entitled to claim as a credit against their 1988 tax?

a. $0
b. $25
c. $50
d. $100

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2M88#8. The maximum allowable credit for political contributions on a 1987 joint return is
a. $100
b. $50
c. $25
d. $0

G. Statute of Limitations

2N90#21. Keen, a calendar-year taxpayer, reported a gross income of $100,000 on his 1989 income tax return. Inadvertently omitted from gross income was a $20,000 commission that should have been included in 1989. Keen filed his 1989 return on March 15, 1990. To collect the tax on the $20,000 omission, the Internal Revenue Service must assert a notice of deficiency no later than
b. April 15, 1993.
d. April 15, 1996.

2N90#22. If an individual paid income tax in 1989 but did not file a 1989 return because his income was insufficient to require the filing of a return, the deadline for filing a refund claim is
a. Two years from the date the tax was paid.
b. Two years from the date a return would have been due.
c. Three years from the date the tax was paid.
d. Three years from the date a return would have been due.

2M89#56. On April 15, 1989, a married couple filed their joint 1988 calendar-year return showing gross income of $80,000. Their return had been prepared by a professional tax preparer who mistakenly omitted $30,000 of income which, in good faith, the preparer considered to be nontaxable. No information with regard to this omitted income was disclosed on the return or attached statements. By what date must the Internal Revenue Service assert a notice of deficiency before the statute of limitations expires?


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.
2M97#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.

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

2M91#35. Fred and Amy Kehl, both U.S. citizens, are married. All of their real and personal property is owned by them as tenants by the entirety or as joint tenants with right of survivorship. The gross estate of the first spouse to die
a. Includes 50% of the value of all property owned by the couple, regardless of which spouse furnished the original consideration.
b. Includes only the property that had been acquired with the funds of the deceased spouse.
c. Is governed by the federal statutory provisions relating to jointly held property, rather than by the decedent’s interest in community property vested by state law, if the Kehls reside in a community property state.
d. Includes one-third of the value of all real estate owned by the Kehls, as the dower right in the case of the wife or curtesy right in the case of the husband.

2M91#36. In connection with a “buy-sell” agreement funded by a cross-purchase insurance arrangement, business associate Adam bought a policy on Burr’s life to finance the purchase of Burr’s interest. Adam, the beneficiary, paid the premiums and retained all incidents of ownership. On the death of Burr, the insurance proceeds will be
a. Includible in Burr’s gross estate, if Burr owns 50% or more of the stock of the corporation.
b. Includible in Burr’s gross estate only if Burr had purchased a similar policy on Adam’s life at the same time and for the same purpose.
c. Includible in Burr’s gross estate, if Adam has the right to veto Burr’s power to borrow on the policy that Burr owns on Adam’s life.
d. Excludible from Burr’s gross estate.

2M91#38. The charitable contribution deduction on an estate’s fiduciary income tax return is allowable
a. If the decedent died intestate.
b. To the extent of the same adjusted gross income limitation as that on an individual income tax return.
c. Only if the decedent’s will specifically provides for the contribution.
d. Subject to the 2% threshold on miscellaneous itemized deductions.

2M91#39. Raff died in 1989 leaving her entire estate to her only child. Raff’s will gave full discretion to the estate’s executor with regard to distributions of income. For 1990, the estate’s distributable net income was $15,000, of which $9,000 was paid to the beneficiary. None of the income was tax exempt. What amount can be claimed on the estate’s 1990 fiduciary income tax return for the distributions deduction?
a. $0
b. $ 6,000
c. $ 9,000
d. $15,000

2M91#40. On July 1, 1989, Vega made a transfer by gift in an amount sufficient to require the filing of a gift tax return. Vega was still alive in 1990. If Vega did not request an extension of time for filing the 1989 gift tax return, the due date for filing was
b. April 15, 1990.

2M90#35. Jan, an unmarried individual, gave the following outright gifts in 1989:

<table>
<thead>
<tr>
<th>Donee</th>
<th>Amount</th>
<th>Use by donee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones</td>
<td>$15,000</td>
<td>Downpayment on house</td>
</tr>
<tr>
<td>Craig</td>
<td>12,000</td>
<td>College tuition</td>
</tr>
<tr>
<td>Kande</td>
<td>5,000</td>
<td>Vacation trip</td>
</tr>
</tbody>
</table>

Jan’s 1989 exclusions for gift tax purposes should total
a. $27,000
b. $25,000
c. $20,000
d. $ 9,000

2M90#36. When Jim and Nina became engaged in April 1989, Jim gave Nina a ring that had a fair market value of $50,000. After their wedding in July 1989, Jim
Selected Questions

gave Nina $75,000 in cash so that Nina could have her own bank account. Both Jim and Nina are U.S. citizens. What was the amount of Jim's 1989 marital deduction?

- $0
- $75,000
- $115,000
- $125,000

2N90#37. Following are the fair market values of Wald's assets at the date of death:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal effects and jewelry</td>
<td>$150,000</td>
</tr>
<tr>
<td>Land bought by Wald with Wald's funds five years prior to death</td>
<td>$800,000</td>
</tr>
</tbody>
</table>
| Wald's sister as joint tenants with right of survivorship | $2M89#57. If an individual donor makes a gift of future interest whereby the donee is to receive possession of the gift at some future time, the annual exclusion for gift tax purposes is

- $0
- $3,000
- $5,000
- $10,000

2N90#38. If the executor of a decedent's estate elects the alternate valuation date and none of the property included in the gross estate has been sold or distributed, the estate assets must be valued as of how many months after the decedent's death?

- 3
- 6
- 9
- 12

2N90#39. Income in respect of a cash basis decedent

- Covers income earned before the taxpayer's death but not collected until after death.
- Receives a stepped up basis in the decedent's estate.
- Must be included in the decedent's final income tax return.
- Cannot receive capital gain treatment.

2N90#40. Which one of the following is a valid deduction from a decedent's gross estate?

- Expenses of administering and settling the estate.
- State inheritance tax.
- Income tax paid on income earned and received after the decedent's death.
- Federal estate tax.

2N90#58. If an individual donor makes a gift of future interest whereby the donee is to receive possession of the gift at some future time, the annual exclusion for gift tax purposes is

- $0
- $3,000
- $5,000
- $10,000

2N90#39. Eng and Lew, both U.S. citizens, died in 1989. Eng made taxable lifetime gifts of $100,000 that are not included in Eng's gross estate. Lew made no lifetime gifts. At the dates of death, Eng's gross estate was $300,000, and Lew's gross estate was $400,000. A federal estate tax return must be filed for

<table>
<thead>
<tr>
<th>Eng</th>
<th>Lew</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

2N90#60. With regard to the federal estate tax, the alternate valuation date

- Is required to be used if the fair market value of the estate's assets has increased since the decedent's date of death.
- If elected on the first return filed for the estate, may be revoked in an amended return provided that the first return was filed on time.
- Must be used for valuation of the estate's liabilities if such date is used for valuation of the estate's assets.
- Can be elected only if its use decreases both the value of the gross estate and the estate tax liability.

2N88#17. Raff created a joint bank account for himself and his friend's son, Dave. There is a gift to Dave when

- Raff creates the account.
- Raff dies.
- Dave draws on the account for his own benefit.
- Dave is notified by Raff that the account has been created.

2N88#18. Proceeds of a life insurance policy payable to the estate's executor, as the estate's representative, are

- Includible in the decedent's gross estate only if the premiums had been paid by the insured.
- 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.
- Always includible in the decedent's gross estate.
- Never includible in the decedent's gross estate.

2M89#57. If no extensions of time for filing were granted, within how many months after the date of a decedent's death is the required federal estate tax return due?

- 3½
- 4½
- 6
- 9
2M88#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.

2M88#20. In 1987, Blum, who is single, gave an outright gift of $50,000 to a friend, Gould, who needed the money to pay medical expenses. In filing the 1987 gift tax return, Blum was entitled to a maximum exclusion of

a. $20,000
b. $10,000
c. $3,000
d. $0

2M88#17. All trusts, except tax exempt trusts,

a. Must adopt a calendar year, except for existing trusts with fiscal years ended in 1987.
b. May adopt a calendar year or any fiscal year.
c. Must adopt a calendar year regardless of the year the trust was established.
d. Must use the same taxable year as that of its principal beneficiary.

2M88#18. For income tax purposes, all estates

a. Must adopt a calendar year, except for existing estates with fiscal years ended in 1987.
b. May adopt a calendar year or any fiscal year.
c. Must adopt a calendar year regardless of the year the estate was established.
d. Must use the same taxable year as that of its principal beneficiary.

2M88#19. With regard to estimated income tax, estates

a. Must make quarterly estimated tax payments starting no later than the second quarter following the one in which the estate was established.
b. Are exempt from paying estimated tax during the estate's first two taxable years.
c. Must make quarterly estimated tax payments only if the estate's income is required to be distributed currently.
d. Are not required to make payments of estimated tax.

2M88#20. A complex trust is a trust that

a. Must distribute income currently, but is prohibited from distributing principal during the taxable year.
b. Invests only in corporate securities and is prohibited from engaging in short-term transactions.
c. Permits accumulation of current income, provides for charitable contributions, or distributes principal during the taxable year.
d. Is exempt from payment of income tax since the tax is paid by the beneficiaries.

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

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. 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>

*The item omitted can be found in other Content Specification Groups.
Selected Questions

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

A. Determination of Taxable Income or Loss

2M91#44. The rule limiting the allowability of passive activity losses and credits applies to
a. Partnerships.
   b. S corporations.
   c. Personal service corporations.
   d. Widely-held C corporations.

2M91#45. Nyle Corp. owned 100 shares of Beta Corp. stock that it bought in 1980 for $9 per share. In 1990, when the fair market value of the Beta stock was $20 per share, Nyle distributed this stock to a noncorporate shareholder. Nyle's recognized gain on this distribution was
a. $2,000
b. $1,100
c. $900
d. $0

2M91#46. A corporation's capital losses are
a. Deductible only to the extent of the corporation's capital gains.
b. Deductible from the corporation's ordinary income to the extent of $3,000.
c. Carried back three years and forward 15 years.
d. Forfeited if the corporation had no capital gains in the year in which the capital losses were incurred.

2M91#47. The corporate dividends-received deduction
a. Must exceed the applicable percentage of the recipient shareholder's taxable income.
b. Is affected by a requirement that the investor corporation must own the investee's stock for a specified minimum holding period.
c. Is unaffected by the percentage of the investee's stock owned by the investor corporation.
d. May be claimed by S corporations.

2M91#49. Foreign income taxes paid by a corporation
a. May be claimed either as a deduction or as a credit, at the option of the corporation.
b. May be claimed only as a deduction.
c. May be claimed only as a credit.
d. Do not qualify either as a deduction or as a credit.

2M91#50. Under the modified accelerated cost recovery system (MACRS) of depreciation for property placed in service after 1986,
a. Used tangible depreciable property is excluded from the computation.
b. Salvage value is ignored for purposes of computing the MACRS deduction.

c. No type of straight-line depreciation is allowable.
d. The recovery period for depreciable realty must be at least 27.5 years.

2M91#51. The minimum total voting power that a parent corporation must have in a subsidiary's stock in order to be eligible for the filing of a consolidated return is
a. 20%
b. 50%
c. 51%
d. 80%

2M91#52. With regard to depreciation computations made under the general MACRS method, the half-year convention provides that
a. One-half of the first year's depreciation is allowed in the year in which the property is placed in service, regardless of when the property is placed in service during the year, and a half-year's depreciation is allowed for the year in which the property is disposed of.
b. The deduction will be based on the number of months the property was in service, so that one-half month's depreciation is allowed for the month in which the property is placed in service and for the month in which it is disposed of.
c. Depreciation will be allowed in the first year of acquisition of the property only if the property is placed in service no later than June 30 for calendar-year corporations.
d. Depreciation will be allowed in the last year of the property's economic life only if the property is disposed of after June 30 of the year of disposition for calendar-year corporations.

2M91#53. When a consolidated return is filed by an affiliated group of includable corporations connected from inception through the requisite stock ownership with a common parent,
a. Intercompany dividends are excludable to the extent of 80%.
b. Operating losses of one member of the group offset operating profits of other members of the group.
c. The parent's basis in the stock of its subsidiaries is unaffected by the earnings and profits of its subsidiaries.
d. Each of the subsidiaries is entitled to an accumulated earnings tax credit.

2M90

Items 29 through 34 are based on the following:

John Budd is the sole stockholder of Ral Corp., an accrual basis taxpayer engaged in wholesaling operations. Ral's retained earnings at January 1, 1989
amounted to $1,000,000. For the year ended December 31, 1989, Ra’s book income, before federal income tax, was $300,000. Included in the computation of this $300,000 were the following:

Dividends received on 500 shares of stock of a taxable domestic corporation that had 1,000,000 shares of stock outstanding (Ra had no portfolio indebtedness) $  1,000
Loss on sale of investment in stock of unaffiliated corporation (this stock had been held for two years; Ra had no other capital gains or losses) (5,000)
Keyman insurance premiums paid on Budd’s life (Ra is the beneficiary of this policy) 3,000
Group term insurance premiums paid on $10,000 life insurance policies for each of Ra’s four employees (the employees’ spouses are the beneficiaries) 4,000
Amortization of cost of acquiring a perpetual dealer’s franchise (Ra paid $48,000 for this franchise on July 1, 1989, and is amortizing it over a 48-month period) 6,000
Contribution to a recognized, qualified charity (this contribution was authorized by Ra’s board of directors in December 1989, to be paid on January 31, 1990) 75,000

On December 1, 1989, Ra received advance rental of $27,000 from a tenant for a three-year lease commencing January 1, 1990 to cover rents for the years 1990, 1991, and 1992. In conformity with GAAP, Ra did not include any part of this rental in its income statement for the year ended December 31, 1989.

29. What portion of the dividend revenue should be included in Ra’s 1989 taxable income?
   a. $150
   b. $200
   c. $300
   d. $900

30. In computing taxable income for 1989, Ra should deduct a capital loss of
   a. $0
   b. $2,500
   c. $3,000
   d. $5,000

31. What amount should Ra include in its 1989 taxable income for rent revenue?
   a. $0
   b. $ 750
   c. $ 9,000
   d. $27,000

32. What amount should Ra deduct for keyman and group life insurance premiums in computing taxable income for 1989?
   a. $0
   b. $3,000
   c. $4,000
   d. $7,000

33. What amount is deductible in Ra’s 1989 return for purchase of the dealer’s franchise?
   a. $0
   b. $ 600
   c. $1,200
   d. $6,000

34. With regard to Ra’s contribution to the recognized, qualified charity, Ra
   a. Can elect to deduct in its 1989 return any portion of the $75,000 that does not exceed the deduction ceiling for 1989.
   b. Cannot deduct any portion of the $75,000 in 1989 because the contribution was not paid in 1989.
   c. Can deduct the entire $75,000 in its 1989 return because Ra reports on the accrual basis.
   d. Can elect to carry forward indefinitely any portion of the $75,000 not deducted in 1989 or 1990.

2M90#35. For the year ended December 31, 1989, Maple Corp.’s book income, before federal income tax, was $100,000. Included in this $100,000 were the following:

Provision for state income tax $1,000
Interest earned on U.S. Treasury Bonds 6,000
Interest expense on bank loan to purchase U.S. Treasury Bonds 2,000

Maple’s taxable income for 1989 was
   a. $ 96,000
   b. $ 97,000
   c. $100,000
   d. $101,000

2M90#36. In the consolidated income tax return of a corporation and its wholly-owned subsidiary, what percentage of cash dividends paid by the subsidiary to the parent is tax-free?
   a. 0%
   b. 70%
   c. 80%
   d. 100%
Items 41 through 46 are based on the following:

Kell Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$900,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$600,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>$300,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>$250,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Total</td>
<td>$78,000</td>
</tr>
<tr>
<td>Other expense</td>
<td>$8,000</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

41. The gain on sale of investments resulted from the sale of stock of an unrelated taxable domestic corporation. This stock had been purchased in 1980. In its 1988 income tax return, Kell should claim a long-term capital gain deduction of
   a. $0
   b. $6,000
   c. $9,000
   d. $12,000

42. The life insurance policy proceeds represent a lump-sum payment in full as a result of the death of Kell's controller. Kell was the owner and beneficiary of this policy. In its 1988 income tax return, Kell should report taxable life insurance proceeds of
   a. $10,000
   b. $8,000
   c. $5,000
   d. $0

43. The dividends were declared and received in 1988 from an unrelated taxable domestic corporation in which Kell owned less than 1% of the investee’s stock. Kell had no portfolio indebtedness. In its 1988 income tax return, Kell should claim a dividends-received deduction of
   a. $0
   b. $100
   c. $2,100
   d. $2,400

44. All of the contributions were to qualified charitable organizations. When Kell computes the maximum allowable deduction for contributions, what percentage of contribution base income should Kell use?
   a. 50%
   b. 30%
   c. 10%
   d. 5%

45. Included in Kell’s operating expenses were the following life insurance premiums:
   - Term life insurance premiums paid on the life of Kell's controller, with Kell as owner and beneficiary of the policy: $2,000
   - Group-term life insurance premiums paid on employees' lives, with the employees' dependents as owners and beneficiaries of the policies: $18,000

In its 1988 income tax return, what amount should Kell deduct for life insurance premiums?
   a. $20,000
   b. $18,000
   c. $2,000
   d. $0

46. Included in Kell's operating expenses is $4,000 for depreciation of a machine that Kell purchased and placed in service in January 1988 for use in the active conduct of Kell's business. This machine cost $32,000 and has an estimated useful life of eight years, with no salvage value. No other fixed assets were acquired during 1988. Kell has taxable income and wishes to minimize its 1988 income tax to the fullest possible extent. The proper election was made in connection with the tax treatment of this machine in Kell's 1988 income tax return. Excluding normal depreciation, Kell may expense on this machine a maximum of
   a. $0
   b. $5,000
   c. $10,000
   d. $32,000

With regard to consolidated returns, which one of the following statements is correct?
   a. The common parent must directly own 51% or more of the total voting power of all corporations included in the consolidated return.
   b. Of all intercompany dividends paid by the subsidiaries to the parent, 70% are excludible from taxable income on the consolidated return.
   c. Only corporations that issue their audited financial statements on a consolidated basis may file consolidated tax returns.
   d. Operating losses of one group member may be used to offset operating profits of the other members included in the consolidated return.

The following information pertains to treasury stock sold by Lee Corp. to an unrelated broker in 1987:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds received</td>
<td>$50,000</td>
</tr>
<tr>
<td>Cost</td>
<td>30,000</td>
</tr>
<tr>
<td>Par value</td>
<td>9,000</td>
</tr>
</tbody>
</table>

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Accounting Practice

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

2M88#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.

2M88#24. In 1988, Kara Corp. incurred the following expenditures in connection with the repurchase of its stock from shareholders to avert a hostile takeover:

Interest on borrowings used to repurchase stock $100,000
Legal and accounting fees in connection with the repurchase 400,000

The total of the above expenditures deductible in 1988 is

a. $0
b. $100,000
c. $400,000
d. $500,000

2M88#25. 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>51%</td>
</tr>
<tr>
<td>c. 80%</td>
<td>51%</td>
</tr>
<tr>
<td>d. 80%</td>
<td>80%</td>
</tr>
</tbody>
</table>

2M88#26. 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#27. 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 Sec-

tion 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:

- Provision for federal income tax $27,000
- Net long-term capital loss 5,000
- Keyman life insurance premiums (corporation is beneficiary) 3,000

Dodd’s 1987 taxable income was

a. $127,000
b. $130,000
c. $132,000
d. $135,000
2M88#28. Consolidated returns may be filed
a. Either by parent-subsidiary corporations or by brother-sister corporations.
b. Only by corporations that formally request advance permission from the IRS.
c. Only by parent-subsidiary affiliated groups.
d. Only by corporations that issue their financial statements on a consolidated basis.

2N87

Items 21 through 26 are based on the following data:

Eric Bay was the sole stockholder of Lee Corp., an accrual basis taxpayer engaged principally in retailing operations. Lee’s retained earnings at December 31, 1986, amounted to $2,000,000. For the year ended December 31, 1987, Lee’s book income, before income taxes, was $600,000. Included in the computation of this $600,000 were the following:

- Gain on sale of land used in business: $20,000
- Loss on sale of long-term investments in marketable securities: $30,000
- Dividend income from unaffiliated taxable domestic corporations: $4,000
- Keyman insurance premiums paid on Bay’s life (Lee is beneficiary): $1,000
- Group term life insurance premiums paid on $25,000 life insurance policies for employees (employees’ dependents are beneficiaries): $15,000
- Contribution to State University, authorized by Board of Directors in December 1987; to be paid March 3, 1988: $100,000
- Amortization of organization costs (total organization costs of $6,000 were incurred in January 1984, and are being amortized over a 10-year period for financial statement purposes): $600

In 1980, Lee had reacquired 1,000 shares of its own $10 par common stock at a cost of $25,000. This stock was held as treasury stock until May 1987, when it was reissued to James Smith at its fair market value of $33,000.

21. In computing taxable income for 1987, Lee should deduct a net capital loss of
   a. $15,000
   b. $10,000
   c. $5,000
   d. $0

22. The dividend income Lee should include in its 1987 taxable income is
   a. $4,000
   b. $3,200
   c. $800
   d. $0

23. In computing taxable income for 1987, what amount should Lee deduct for keyman and group life insurance premiums?
   a. $8,000
   b. $15,000
   c. $15,500
   d. $16,000

24. With regard to Lee’s contribution to State University, Lee can
   a. Not deduct any portion of the $100,000 in 1987, because the contribution was not paid until 1988.
   b. Deduct the entire $100,000 in its 1987 return.
   c. Elect to carry back to 1986 a portion of the $100,000 that does not exceed the deduction ceiling for 1986 and 1987.
   d. Elect to deduct in its 1987 return any portion of the $100,000 that does not exceed the deduction ceiling for 1987.

25. In computing taxable income for 1987, what is the maximum deduction that Lee can claim for organization costs, assuming that the appropriate election was made on a timely basis?
   a. $1,200
   b. $600
   c. $300
   d. $0

26. How much should Lee report in its 1987 return as long-term capital gain on the issuance of its treasury stock to Smith?
   a. $0
   b. $8,000
   c. $23,000
   d. $33,000

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
2M87#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.

2M88

Items 47 through 49 are based on the following data:

Ram Corp.'s operating income for the year ended December 31, 1987 amounted to $100,000. In addition, Ram received $2,000 in dividends from an unrelated taxable domestic corporation in 1987. Included in Ram's 1987 operating expenses is a $6,000 insurance premium on a policy insuring the life of Ram's president. Ram is beneficiary of this policy. Also in 1987, a machine owned by Ram was completely destroyed in an accident. This machine's adjusted basis immediately before the casualty was $15,000. The machine was not insured and had no salvage value.

47. In Ram's 1987 tax return, what amount should be included in taxable income for the dividends?
   a. $ 300
   b. $ 400
   c. $1,600
   d. $1,700

48. In Ram's 1987 tax return, what amount should be deducted for the $6,000 life insurance premium?
   a. $6,000
   b. $5,000
   c. $1,000
   d. $0

49. In Ram's 1987 tax return, what amount should be deducted for the casualty loss?
   a. $ 5,000
   b. $ 5,400
   c. $14,900
   d. $15,000

2M87#50. For the first taxable year in which a corporation has qualifying research and experimental expenditures, the corporation
   a. Has a choice of either deducting such expenditures as current business expenses, or capitalizing these expenditures.
   b. Has to treat such expenditures in the same manner as they are accounted for in the corporation's financial statements.
   c. Is required to deduct such expenditures currently as business expenses or lose the deductions.
   d. Is required to capitalize such expenditures and amortize them ratably over a period of not less than 60 months.

B. Tax Computations and Credits

2M90#37. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is
   a. Subtracted from the regular tax.
   b. Payable in addition to the regular tax.
   c. Carried back to the third preceding taxable year.
   d. Carried back to the first preceding taxable year.

2M89#47. In the computation of a corporation's taxable income for a particular year, a net capital loss sustained in that year is
   a. Limited to a maximum deduction of $3,000.
   b. Deductible in full.
   c. Deductible to a maximum extent of 50%.
   d. Not deductible.

2M88#29. Except for transition property, qualified progress expenditures, and qualified timber property, the regular 10% investment tax credit
   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.
2M87#51. A corporation may reduce its income tax by taking a tax credit for
   a. Accelerated depreciation.
   b. State income taxes.
   c. Foreign income taxes.
   d. Dividends-received exclusion.

C. S Corporations

2M91#56. Bern Corp., an S corporation, had an ordinary loss of $36,500 for the year ended December 31, 1990. At January 1, 1990, Meyer owned 50% of Bern's stock. Meyer held the stock for 40 days in 1990 before selling the entire 50% interest to an unrelated third party. Meyer's basis for the stock was $10,000. Meyer was a full-time employee of Bern until the stock was sold. Meyer's share of Bern's 1990 loss was
   a. $0
   b. $2,000
   c. $10,000
   d. $18,250

2M91#57. After a corporation's status as an S corporation is revoked or terminated, how many years is the corporation required to wait before making a new S election, in the absence of IRS consent to an earlier election?
   a. 1
   b. 3
   c. 5
   d. 10

2M90#27. Which one of the following will render a corporation ineligible for S corporation status?
   a. One of the stockholders is a decedent's estate.
   b. One of the stockholders is a bankruptcy estate.
   c. The corporation has both voting and nonvoting common stock issued and outstanding.
   d. The corporation has 50 stockholders.

2M89#50. With regard to S corporations and their stockholders, the "at risk" rules applicable to losses
   a. Depend on the type of income reported by the S corporation.
   b. Are subject to the elections made by the S corporation's stockholders.
   c. Take into consideration the S corporation's ratio of debt to equity.
   d. Apply at the shareholder level rather than at the corporate level.

2M89#51. An S corporation may deduct
   a. Charitable contributions within the percentage of income limitation applicable to corporations.
   b. Net operating loss carryovers.
   c. Foreign income taxes.
   d. Compensation of officers.

2N88#25. An S corporation's accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,
   a. Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
   b. Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
   c. Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
   d. Is not adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.

2M88#30. To be eligible for S corporation status, a corporation can
   a. Not have a decedent's estate as a stockholder.
   b. Not have a bankruptcy estate as a stockholder.
   c. Have both voting and nonvoting common stock issued and outstanding.
   d. Not have more than 25 stockholders.

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 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
D. Personal Holding Companies

The following information pertains to Hull, Inc., a personal holding company, for the year ended December 31, 1990:

Undistributed personal holding company income
Dividends paid during 1990
Consent dividends reported in the 1990 individual income tax returns of the holders of Hull's common stock, but not paid by Hull to its stockholders

In computing its 1990 personal holding company tax, what amount should Hull deduct for dividends paid?

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

Ati Corp. has two common stockholders. Ati derives all of its income from investments in stocks and securities, and it regularly distributes 51% of its taxable income as dividends to its stockholders. Ati is

a. Personal holding company.
b. Regulated investment company.
c. Corporation subject to the accumulated earnings tax.
d. Corporation subject to tax only on income not distributed to stockholders.

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 Madga, 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.

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:

Net rental income
Commissions earned on sales of franchises
Dividends from taxable domestic corporations

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

E. Accumulated Earnings Tax

The accumulated earnings tax can be imposed

a. Regardless of the number of stockholders of a corporation.
b. On personal holding companies.
c. On companies that make distributions in excess of accumulated earnings.
d. On both partnerships and corporations.

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.
F. Distributions

2M88#52. How does a noncorporate shareholder treat the gain on a redemption of stock that qualifies as a partial liquidation of the distributing corporation?
   a. Entirely as capital gain.
   b. Entirely as a dividend.
   c. Partly as capital gain and partly as a dividend.
   d. As a tax-free transaction.

2M88#31. The following information pertains to Ral Corp.:

Accumulated earnings and profits at January 1, 1987 $30,000
Earnings and profits for the year ended December 31, 1987 40,000
Cash distributions to individual stockholders in 1987 90,000

What is the total amount of distributions taxable as dividend income to Ral's stockholders in 1987?
   a. $0
   b. $40,000
   c. $70,000
   d. $90,000

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

G. Tax-Free Incorporation

2M89#53. Rela Associates, a partnership, transferred all of its assets, with a basis of $300,000, subject to liabilities of $50,000, to a newly formed corporation in return for all of the corporation's stock. Rela then distributed this stock to the partners in liquidation. In connection with this incorporation of the partnership, Rela recognizes
   a. No gain or loss on the transfer of its assets nor on the assumption of Rela's liabilities by the corporation.
   b. Gain on the assumption of Rela's liabilities by the corporation.
   c. Gain or loss on the transfer of its assets to the corporation.
   d. Gain, but not loss, on the transfer of its assets to the corporation.

2M88#34. In 1987, Dr. James Pyle, a cash basis taxpayer, incorporated his dental practice. No liabilities were transferred. The following assets were transferred to the corporation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (checking account)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>60,000</td>
</tr>
<tr>
<td>Fair market value</td>
<td>68,000</td>
</tr>
</tbody>
</table>

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%

H. Reorganizations

2M91#43. Pursuant to a plan of corporate reorganization adopted in July 1990, Gow exchanged 500 shares of Lad Corp. common stock that he had bought in January 1990 at a cost of $5,000 for 100 shares of Rook Corp. common stock having a fair market value of $6,000. Gow's recognized gain on this exchange was
   a. $1,000 long-term capital gain.
   b. $1,000 short-term capital gain.
   c. $1,000 ordinary income.
   d. $0.

2M88#32. Which one of the following is a corporate reorganization as defined in the Internal Revenue Code?
   a. Mere change in place of organization of one corporation.
   b. Stock redemption.
   c. Change in depreciation method from accelerated to straight-line.
   d. Change in inventory costing method from FIFO to LIFO.

2M88#32. The accumulated earnings tax does not apply to
   a. Corporations that have more than 100 stockholders.
   b. Personal holding companies.
   c. Corporations filing consolidated returns.
   d. Corporations that have more than one class of stock.
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.

I. Liquidations and Dissolutions

Krol Corp. distributed marketable securities in redemption of its stock in a complete liquidation. On the date of distribution, these securities had a basis of $100,000 and a fair market value of $150,000. What gain does Krol have as a result of the distribution?

a. $0.
b. $50,000 capital gain.
c. $50,000 Section 1231 gain.
d. $50,000 ordinary gain.

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.

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 $120,000. 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

J. Formation of Partnership

On June 1, 1988, Don Kerr received a 10% interest in the capital of Rev Company, a partnership, for services rendered. Rev’s net assets at June 1 had a basis of $35,000 and a fair market value of $50,000. What income must Kerr include in his 1988 tax return for the partnership interest transferred to him by the other partners?

a. $5,000 capital gain.
b. $5,000 ordinary income.
c. $3,500 capital gain.
d. $3,500 ordinary income.

The following information pertains to Carr’s admission to the Smith & Jones partnership on July 1, 1988:

Carr’s contribution of capital: 800 shares of Ed Corp. stock bought in 1975 for $30,000; fair market value $150,000 on July 1, 1988.

Carr’s interest in capital and profits of Smith & Jones: 25%.

Fair market value of net assets of Smith & Jones on July 1, 1988 after Carr’s admission: $600,000.

Carr’s gain in 1988 on the exchange of the Ed stock for Carr’s partnership interest was

a. $120,000 ordinary income.
b. $120,000 long-term capital gain.
c. $120,000 Section 1231 gain.
d. $0.

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

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

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
Selected Questions

K. Basis of Partner's Interest

2M91#58. Eng contributed the following assets to a partnership in exchange for a 50% interest in the partnership's capital and profits:

Cash $50,000
Equipment:
   Fair market value 35,000
   Carrying amount (adjusted basis) 25,000

The basis for Eng's interest in the partnership is
a. $37,500
b. $42,500
c. $75,000
d. $85,000

2M88#34. The following information pertains to land contributed by Pink for a 50% interest in a new partnership:

Adjusted basis to Pink $100,000
Fair market value 300,000
Mortgage assumed by partnership 30,000

The basis for Pink's partnership interest is
a. $70,000
b. $85,000
c. $100,000
d. $300,000

2M88#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

2M88#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.

2M87#54. The following information pertains to land contributed by Bea Dott for a 30% 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

L. Determination of Partner's Taxable Income and Partner's Elections

2M90#24. Dale's distributive share of income from the calendar-year partnership of Dale & Eck was $50,000 in 1989. On December 15, 1989, Dale, who is a cash-basis taxpayer, received a $27,000 distribution of the partnership's 1989 income, with the $23,000 balance paid to Dale in May 1990. In addition, Dale received a $10,000 interest-free loan from the partnership in 1989. This $10,000 is to be offset against Dale's share of 1990 partnership income. What total amount of partnership income is taxable to Dale in 1989?

a. $27,000
b. $37,000
c. $50,000
d. $60,000

2M88#36. Dunn and Shaw are partners who share profits and losses equally. In the computation of the partnership's 1987 book income of $100,000, guaranteed payments to partners totaling $60,000 and charitable contributions totaling $1,000 were treated as expenses. What amount should be reported as ordinary income on the partnership's 1987 return?

a. $100,000
b. $101,000
c. $160,000
d. $161,000

M. Accounting Periods of Partnership and Partners

2M90#25. Which one of the following statements regarding a partnership's tax year is correct?

a. A partnership formed on July 1 is required to adopt a tax year ending on June 30.
b. A partnership may elect to have a tax year other than the generally required tax year if the deferral period for the tax year elected does not exceed three months.
c. A "valid business purpose" can no longer be claimed as a reason for adoption of a tax year other than the generally required tax year.
d. Within 30 days after a partnership has established a tax year, a form must be filed with the IRS as notification of the tax year adopted.

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N. Partner Dealing With Own Partnership

2M91#50. Under the Internal Revenue Code sections pertaining to partnerships, guaranteed payments are payments to partners for
a. Payments of principal on secured notes honored at maturity.
b. Timely payments of periodic interest on bona fide loans that are not treated as partners' capital.
c. Services or the use of capital without regard to partnership income.
d. Sales of partners' assets to the partnership at guaranteed amounts regardless of market values.

2N09#56. Doris and Lydia are equal partners in the capital and profits of Agee & Nolan, but are otherwise unrelated. The following information pertains to 300 shares of Mast Corp. stock sold by Lydia to Agee & Nolan:

<table>
<thead>
<tr>
<th>Year of purchase</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of sale</td>
<td>1988</td>
</tr>
<tr>
<td>Basis (cost)</td>
<td>$9,000</td>
</tr>
<tr>
<td>Sales price (equal to fair market value)</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

The amount of long-term capital loss that Lydia realized in 1988 on the sale of this stock was
a. $5,000
b. $3,000
c. $2,500
d. $0

2N08#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.

2N07#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

2M91#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

O. Treatment of Liabilities

2M91#60. Beck and Nilo are equal partners in B&N Associates, a general partnership. B&N borrowed $10,000 from a bank on an unsecured note, thereby increasing each partner's share of partnership liabilities. As a result of this loan, the basis of each partner's interest in B&N was
a. Increased.
b. Decreased.
c. Unaffected.
d. Dependent on each partner's ability to meet the obligation if called upon to do so.

P. Distribution of Partnership Assets

2M90#26. Hart's adjusted basis of his interest in a partnership was $30,000. He received a nonliquidating distribution of $24,000 cash plus a parcel of land with a fair market value and partnership basis of $9,000. Hart's basis for the land is
a. $9,000
b. $6,000
c. $3,000
d. $0

2N89#57. 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. Fair market value of the property.
b. Book value of the property.
c. Adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction.
d. Adjusted basis of such partner's interest in the partnership, increased by any money distributed in the same transaction.

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>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Before this distribution, Reed's basis in Post was $25,000.
38. If this distribution were nonliquidating, Reed's recognized gain or loss on the distribution would be
   a. $11,000 gain.
   b. $ 9,000 loss.
   c. $ 1,500 loss.
   d. $0.

39. If this distribution were in complete liquidation of Reed's interest in Post, Reed's basis for the land would be
   a. $14,000
   b. $12,500
   c. $ 5,000
   d. $ 1,500

Q. Termination of Partnership

2M80#21. Partnership Abel, Benz, Clark & Day is in the real estate and insurance business. Abel owns a 40\% interest in the capital and profits of the partnership, while Benz, Clark, and Day each owns a 20\% interest. All use a calendar year. At November 1, 1989, the real estate and insurance business is separated, and two partnerships are formed: Partnership Abel & Benz takes over the real estate business, and Partnership Clark & Day takes over the insurance business. Which one of the following statements is correct for tax purposes?

   a. Partnership Abel & Benz is considered to be a continuation of Partnership Abel, Benz, Clark & Day.
   b. In forming Partnership Clark & Day, partners Clark and Day are subject to a penalty surtax if they contribute their entire distributions from Partnership Abel, Benz, Clark & Day.
   c. Before separating the two businesses into two distinct entities, the partners must obtain approval from the IRS.
   d. Before separating the two businesses into two distinct entities, Partnership Abel, Benz, Clark & Day must file a formal dissolution with the IRS on the prescribed form.

2M90

Items 22 and 23 are based on the following:

The personal service partnership of Allen, Baker & Carr had the following cash basis balance sheet at December 31, 1989:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$102,000</td>
<td>$102,000</td>
</tr>
<tr>
<td>Unrealized accounts receivable</td>
<td>—</td>
<td>420,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$102,000</td>
<td>$522,000</td>
</tr>
</tbody>
</table>

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.

2M87#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.
R. Types of Organizations

2M90#39. The private foundation status of an exempt organization will terminate if it
   a. Is governed by a charter that limits the organization's exempt purposes.
   b. Does not distribute all of its net assets to one or more public charities.
   c. Is a foreign corporation.
   d. Becomes a public charity.

2M88#38. Which one of the following types of organizations qualifies as an organization exempt from income tax?
   a. An "action" organization established for the purpose of influencing legislation pertaining to protection of animal rights.
   b. All "feeder" organizations, primarily conducting businesses for profit, but distributing 100% of their profits to organizations exempt from income tax.
   c. A social club organized and operated exclusively for the pleasure and recreation of its members, supported solely by membership fees, dues, and assessments.
   d. An organization whose purpose is to foster national or international amateur sports competition by providing athletic facilities and equipment.

2N88#38. Carita Fund, organized and operated exclusively for charitable purposes, provides insurance coverage, at amounts substantially below cost, to exempt organizations involved in the prevention of cruelty to children. Carita's insurance activities are
   a. Exempt from tax.
   b. Treated as unrelated business income.
   c. Subject to the same tax provisions as those applicable to insurance companies.
   d. Considered "commercial-type" as defined by the Internal Revenue Code.

2M88#39. A condominium management association wishing to be treated as a homeowners association and to qualify as an exempt organization for a particular year
   a. Need not file a formal election.
   b. Must file an election as of the date the association was organized.
   c. Must file an election at the beginning of the association's first taxable year.
   d. Must file a separate election for each taxable year no later than the due date of the return for which the election is to apply.

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.
   c. Can not, under any circumstances, engage in lobbying activities.
   d. Can not be exclusively a social club.

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.

S. Requirements for Exemption

2M90#40. To qualify as an exempt organization, the applicant
   a. May be organized and operated for the primary purpose of carrying on a business for profit, provided that all of the organization's net earnings are turned over to one or more tax exempt organizations.
   b. Need not be specifically identified as one of the classes upon which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.
   c. Must not be classified as a social club.
   d. Must not be a private foundation organized and operated exclusively to influence legislation pertaining to protection of the environment.

2N89#59. To qualify as an exempt organization other than an employees' qualified pension or profit-sharing trust, the applicant
   a. Is barred from incorporating and issuing capital stock.
   b. Must file a written application with the Internal Revenue Service.
   c. Cannot operate under the "lodge system" under which payments are made to its members for sick benefits.
   d. Need not be specifically identified as one of the classes on which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.

2N88#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.

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.
Selected Questions

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.

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.

T. Unrelated Business Income

2M81#41. Salud Welfare Associates is an exempt organization that operates under a corporate charter granted by the state in which Salud's principal office is located. Salud's tax on unrelated business taxable income is
a. Abated.
b. Credited against the tax on recognized capital gains.
c. Computed at rates applicable to trusts.
d. Computed at corporate income tax rates.

2M80#38. An incorporated exempt organization subject to tax on its 1989 unrelated business income
a. Must make estimated tax payments if its tax can reasonably be expected to be $100 or more.
b. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.

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.

2N89#60. With regard to unrelated business income of an exempt organization, which one of the following statements is correct?
a. An unrelated trade or business activity that results in a loss is excluded from the definition of unrelated business.
b. The tax on unrelated business income can be imposed even if the unrelated business activity is intermittent and is carried on once a year.
c. An exempt organization is not taxed on unrelated business income of less than $1,000.
d. An exempt organization that earns any unrelated business income in excess of $100,000 during a particular year will lose its exempt status for that particular year.

2N88#40. The filing of a return covering unrelated business income
a. Is required of all exempt organizations having at least $1,000 of unrelated business taxable income for the year.
b. Relieves the organization of having to file a separate annual information return.
c. Is not necessary if all of the organization's income is used exclusively for charitable purposes.
d. Must be accompanied by a minimum payment of 50% of the tax due as shown on the return, with the balance of tax payable six months later.

2M88#38. An exempt organization subject to tax on its 1988 unrelated business income
a. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
b. Must pay at least 70% of the tax due as shown on the return when filed, with the balance of tax payable in the following quarter.
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.
### I. Presentation of Financial Statements or Worksheets

**A. Balance Sheet**
- 1M91# 8 c
- 1M91# 9 d
- 1M91# 10 a
- 1M91# 11 d
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**B. Income Statement**
- 1M91# 3 d
- 1M91# 5 d
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- 1N89# 7 d
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**C. Statement of Cash Flows**
- 1M91# 4 c
- 1M91# 6 c

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### E. Consolidated Financial Statements or Worksheets
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- 1M89# 57 b
- 1M89# 58 c
- 1N88# 2 a
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- 1M88# 10 b
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- 1M88# 13 a
- 1M88# 14 b
- 1M88# 15 c
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### II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

**A. Cash, Marketable Securities, and Investments**
- 1N87# 1 c
- 1N87# 2 b
- 1N87# 3 c
- 1N87# 6 c
- 1N87# 1 b
- 1M87# 3 a
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- 1N90# 17 b
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- 1N87# 18 b
- 1N87# 19 d
- 1N87# 9 a
- 1N87# 20 b
- 1N87# 4 b
- 1M87# 17 d

**D. Property, Plant, and Equipment Owned or Leased**
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- 1M87# 16 b
- 1M87# 17 d

**C. Inventories**
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- 1M91# 24 c
- 1M91# 25 b
- 1M91# 26 d

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## Accounting Practice

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| 2N90#2 d | 1M89#26 c | 1M90#21 b |
| 2N90#4 a | 1M89#27 b | 1N89#12 a |
| 2N90#5 b | 1M88#23 b | 1M91#22 c |
| 2N90#13 a | 1M88#24 a | 1M91#28 d |
| 1M90#15 c | 1M88#25 c | 1M91#29 b |
| 1M90#16 d | 1M87#7 a | 1M91#30 d |
| 1M90#18 b | 1M87#8 c | 1M91#32 c |
| 1M90#19 b | 1M87#9 d | 1N90#9 a |
| 1M89#23 b | | 1N88#23 d |

#### B. Deferred Revenues

| 1M91#33 b | 1M88#30 b | 1M91#42 a |
| 1M91#34 a | 1M87#8 b | 1N88#28 b |
| 1M91#35 c | 1N87#13 c | 1N89#29 c |
| 1M91#36 b | 1N87#17 b | 1M89#30 a |
| 1M91#37 d | 1N87#5 d | 1M89#31 b |
| 1M91#38 c | 1M87#11 a | 1M89#45 d |
| 1M91#39 b | 1M87#15 d | 1M87#29 c |
| 1N90#10 b | 1M91#40 d | 1M87#25 b |
| 1N90#11 d | 1N90#43 c | 1M87#26 d |
| 1N90#12 d | 1M91#44 b | 1N89#22 d |
| 1N90#13 c | 1M90#17 b | 1N89#27 b |
| 1N90#14 b | 1N90#18 c | 1N89#27 d |
| 1N90#15 d | 1M90#31 d | 1N89#29 c |
| 1N90#16 a | 1N89#23 c | 1M89#44 b |
| 1M90#22 c | 1N90#22 a | 1M89#46 b |
| 1M90#23 d | 1N88#22 a | 1N89#47 c |
| 1M90#26 a | 1N88#29 c | 1N89#49 b |
| 1M90#27 d | 1M88#29 c | 1N88#32 a |
| 1M90#29 a | 1M88#39 c | 1N88#37 c |
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| 1M90#31 c | 1N90#21 a | 1M87#37 b |
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| 1N89#16 c | 1N90#33 c | 1M87#28 b |
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| 1N89#21 d | 1M87#21 c | 1M88#25 b |
| 1M89#24 b | 1M87#22 c | 1M88#30 a |
| 1M89#30 c | 1N90#24 b | 1M88#41 c |
| 1M89#32 d | 1N90#26 b | 1N89#31 b |
| 1M89#35 c | 1N90#27 c | 1N87#31 b |
| 1M89#36 c | 1M90#36 a | 1N87#35 c |
| 1M89#38 d | 1M90#37 a | 1N87#29 b |
| 1N88#13 a | 1M90#38 b | 1N88#27 c |
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| 1N89#26 b | 1N89#25 c | AP-146 |
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<th>E. Stock Options, Warrants, and Rights</th>
<th>G. Partnerships</th>
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<tr>
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<th>D. Treasury Stock and Other Contra Accounts</th>
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<th>C. Retained Earnings and Dividends</th>
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1M87# 48 c  
1N87# 57 d  
1M87# 56 d  

H. Employee Benefits  
2M91# 8 a  
2M91# 9 d  
2M91# 10 a  
1N90# 59 d  
2M90# 59 a  
1N89# 54 d  
1N88# 55 d  
1M88# 58 a  
1M88# 59 c  

K. Personal Financial Statements  
2M91# 18 d  
1N89# 58 d  
2M89# 17 d  
1N88# 59 b  
1M88# 60 a  
1M87# 53 a  

L. Combined Financial Statements  
1N87# 49 d  
1M88# 57 a  
1N87# 58 b  
1N87# 60 c  
1M87# 55 c  
1N88# 58 d  
1M88# 53 b  
1M87# 60 c  

AP-148
Unofficial Answers

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements
   2N89# 33 d  2N89# 32 c
   2N89# 34 b  2M87# 31 c
   2N89# 35 d  2N89# 27 b
   2M87# 23 a  2N89# 28 b
   2M87# 24 c  2M87# 34 b

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
   2N89#29 d  2N89#29 b
   2N89#30 a  2M87#29 b
   2M87#40 a

G. Break-even and Cost-Volume-Profit Analysis
   2M87#35 d  2M87#36 a
   2N89#21 c  2N89#22 c
   2N89#23 c

J. Other
   2N89#47 c

E. Absorption and Variable Costing
   2N89#29 d  2N89#36 b
   2N89#30 a  2N89#40 b
   2M87#37 b  2M87#38 b

F. Budgeting and Flexible Budgeting
   2N89#26 d  2N89#31 a  2N89#37 a
   2M87#32 d  2N89#38 c

C. Standard Costing
   2N89# 26 d  2N89# 31 a
   2M87#32 d

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting
   2N90# 49 b  2N87# 54 d  2M87#35 d  2M87#36 a
   2N90# 52 c  2N87# 55 a  2M87#35 d  2M87#36 a
   2N90# 53 a  2N87# 56 a  2N87#58 b
   2N90# 1 c  2M87#37 d  2M87#38 b
   2N90# 2 d  2M87#38 b
   2N90# 3 c

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
   2N88# 54 a  2N88# 56 d  2N88# 57 d
   2N88# 58 b

D. Various Types of Not-for-Profit and Governmental Organizations
   2N88# 60 a  2N88# 61 b  2N88# 62 c
   2N88# 63 c

B. Types of Funds and Fund Accounts
   2N90# 41 a  2N90# 51 b  2M90#11 a  2N87#41 a
   2N90# 52 c  2M90#12 c  2N87#42 b
   2N90# 53 a  2M90#13 b  2M87#43 b
   2M90# 1 c  2M90#17 b
   2M90# 2 d  2M90#18 a
   2M90# 3 d  2M90#20 c
   2M90# 4 c  2M89#29 a
   2M90# 5 c  2M89#30 d
   2M90# 6 c  2N87#31 d
   2M90# 7 a  2N87#32 c
   2M90# 8 b  2N87#33 c
   2M90# 10 d  2N87#36 b
   2N87#37 b
   2M89#38 b
   2M89#39 b
   2M89#40 a
   2M89#41 a
   2M89#42 b
   2M89#43 c
   2M89#44 c
   2M89#45 c
   2M89#46 c
   2M89#47 c
   2M89#48 b
   2M89#49 c
   2M89#50 d

AP-149
A. Inclusions for Gross Income and Adjusted Gross Income
   2M91#21 a
   2M91#22 a
   2M91#23 d
   2M91#24 b
   2M91#28 a
   2N90#25 a
   2N90#26 c
   2N90#27 c
   2M89#44 a
   2M89#45 c
   2M89#54 a
   2N88#2 d
   2N88#3 b
   2N88#5 d
   2N88#6 a
   2N88#7 c
   2N88#8 b
   2N88#9 d
   2M88#1 a
   2M88#2 d
   2M88#3 d
   2M88#4 b
   2M88#5 a
   2M88#6 d
   2M88#9 a
   2N87#1 b
   2N87#2 a
   2N87#3 c
   2N87#4 d
   2N87#6 d
   2N87#7 a
   2N87#8 c
   2N87#9 b
   2N87#10 a
   2N88#12 d
   2N88#13 c
   2N88#14 a
   2N88#15 b
   2N88#16 c
   2N88#17 b
   2N88#18 b
   2N88#19 a
   2N88#20 a
   2N88#21 b
   2N88#22 a
   2N88#23 d
   2N88#24 b
   2N88#25 a
   2N88#26 c
   2N88#27 c
   2N88#28 a
   2N88#29 c
   2N88#30 a
   2N88#31 d
   2N89#32 d
   2N89#33 c
   2N89#34 c
   2N89#48 d
   2N89#49 b
   2N89#50 b
   2N89#51 b
   2N89#52 a
   2N89#53 b
   2M89#46 c
   2M89#10 d
   2M89#11 a
   2M89#15 c
   2M89#16 c
   2M89#7 b
   2M89#12 d
   2M89#13 c
   2M89#14 a
   2M89#34 b
   2M89#24 a
   2M89#43 a
   2M89#16 c
   2M89#11 a
   2N87#5 two
   2N87#6 three
   2N87#7 four
   2N87#8 five
   2N87#9 six
   2N87#10 seven
   2N87#11 eight
   2N87#12 nine
   2N87#13 ten
   2N87#14 eleven
   2N87#15 twelve
   2N87#16 thirteen
   2N87#17 fourteen
   2N87#18 fifteen
   2N87#19 sixteen
   2N87#20 seventeen
   2N87#21 eighteen
   2N87#22 nineteen

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income
   2M91#35 a
   2M91#36 d
   2M91#37 c
   2M91#38 c
   2M91#39 c
   2N90#35 b
   2N90#36 b
   2N90#37 d
   2N90#38 b
   2N90#39 a
   2N90#40 a
   2M89#57 d
   2M89#58 a
   2M89#59 a
   2M89#60 d
   2N88#17 c
   2N88#18 c
   2N88#19 d
   2N88#20 b
   2M88#17 c
   2M88#18 b
   2M88#19 b
   2M88#20 c
   2M88#21 b
   2M88#22 a
   2M88#23 a
   2M88#24 b
   2M88#25 c
   2M88#26 b
   2M88#27 d
   2M88#28 c
   2M89#34 b
   2M89#24 a
   2M89#43 a
   2M89#16 c
   2M89#11 a
   2N87#5 two
   2N87#6 three
   2N87#7 four
   2N87#8 five
   2N87#9 six
   2N87#10 seven
   2N87#11 eight
   2N87#12 nine
   2N87#13 ten
   2N87#14 eleven
   2N87#15 twelve
   2N87#16 thirteen
   2N87#17 fourteen
   2N87#18 fifteen
   2N87#19 sixteen
   2N87#20 seventeen
   2N87#21 eighteen
   2N87#22 nineteen

C. Gain or Loss on Property Transactions
   2M91#33 c
   2N90#23 c
   2M89#47 a
   2M89#53 c
   2M88#8 d
   2M88#21 b
   2N90#22 a

D. Deductions From Adjusted Gross Income
   2M91#44 c
   2M91#45 b
   2M91#46 a
   2M91#47 b
   2M91#49 a
   2M91#50 b
   2M91#51 d
   2M91#52 a
   2M91#53 b
   2M90#29 c
   2M90#30 a
   2M90#31 d
   2N88#28 d
   2N87#29 d
   2M88#22 d
   2M88#23 d
   2M88#24 b
   2M88#25 c
   2M88#26 b
   2M88#27 d
   2M88#28 c
   2N87#23 b
   2N87#24 d
   2N87#25 a
   2N87#26 a
   2N87#28 c
   2M87#51 c

E. Filing Status and Exemptions
   2M91#33 c
   2N90#23 c
   2M89#47 a
   2M89#53 c
   2M88#8 d
   2M88#21 b
   2N90#22 a

F. Tax Computations and Credits
   2M91#33 c
   2N90#23 c
   2M89#47 a
   2M89#53 c
   2M88#8 d
   2M88#21 b
   2N90#22 a

G. Statute of Limitations
   2N87#12 b
   2N87#11 c

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

A. Determination of Taxable Income or Loss
   2M90#32 c
   2M90#33 a
   2M90#34 a
   2M90#35 c
   2M90#36 d
   2M89#41 a
   2M89#42 d
   2M89#43 c
   2M89#44 c
   2M89#45 b
   2M89#46 c
   2M89#48 d
   2M88#22 a
   2M88#23 c
   2N88#24 b
   2N88#28 d
   2N87#29 d
   2M87#42 d
   2M87#46 b
   2M87#47 b
   2M87#48 d
   2M87#49 d
   2M87#50 a

B. Tax Computations and Credits
   2M90#37 b
   2N89#47 d
   2M88#29 a
   2N87#30 c
   2M87#51 c
C. S Corporations

2M91#56 b
2M91#57 c
2M90#27 d
2N89#50 d
2N89#51 d
2N88#25 d
2M88#30 c
2N87#27 c
2M87#43 b

D. Personal Holding Companies

2M91#54 d
2N89#49 a
2N88#29 b
2M88#31 c
2N87#34 c
2M87#44 d

E. Accumulated Earnings Tax

2M91#42 a
2N87#35 d
2M87#41 a

F. Distributions

2N89#52 a
2N88#31 c
2M87#57 b

G. Tax-Free Incorporation

2N89#53 a
2M88#34 c
2M87#45 a

H. Reorganizations

2M91#43 d
2N88#32 a
2M88#32 b
2M87#58 c

I. Liquidations and Dissolutions

2M90#28 b
2N88#33 d
2M87#59 a

J. Formation of Partnership

2N89#54 b
2N89#55 d
2M88#33 a
2M88#35 d
2M87#53 d

K. Basis of Partner’s Interest

2M91#58 c
2N88#34 b
2N88#35 d
2N88#36 b
2M87#54 a

L. Determination of Partner’s Taxable Income and Partner’s Elections

2M90#24 c
2M88#36 b

M. Accounting Periods of Partnership and Partners

2M90#25 b

N. Partner Dealing With Own Partnership

2M91#59 c
2N89#56 a
2N88#37 c
2N87#40 d
2M87#55 a

O. Treatment of Liabilities

2M91#60 a

P. Distribution of Partnership Assets

2M91#41 d
2M90#26 b
2M89#38 b
2N89#60 c
2N89#40 a
2M88#38 a
2N87#31 d

Q. Termination of Partnership

2M90#21 a
2M90#22 a
2M90#23 d
2M88#37 a
2N87#37 c

R. Types of Organizations

2M90#39 d
2N89#58 c
2N88#38 a
2M88#39 d
2N87#33 a
2M87#60 c

S. Requirements for Exemption

2M90#40 d
2N89#59 b
2N88#39 c
2M88#40 d
2N87#32 b
2M87#52 c

T. Unrelated Business Income
PROBLEMS — SELECTED QUESTIONS

1. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M91
Number 4 (Estimated time — 45 to 55 minutes)

Kern, Inc. had the following long-term receivable account balances at December 31, 1989:

Note receivable from the sale of an idle building $750,000
Note receivable from an officer 200,000

Transactions during 1990 and other information relating to Kern's long-term receivables follow:

- The $750,000 note receivable is dated May 1, 1989, bears interest at 9%, and represents the balance of the consideration Kern received from the sale of its idle building to Able Co. Principal payments of $250,000 plus interest are due annually beginning May 1, 1990. Able made its first principal and interest payment on May 1, 1990. Collection of the remaining note installments is reasonably assured.

- The $200,000 note receivable is dated December 31, 1987, bears interest at 8%, and is due on December 31, 1992. The note is due from Frank Black, president of Kern, Inc., and is collateralized by 5,000 shares of Kern's common stock. Interest is payable annually on December 31, and all interest payments were made through December 31, 1990. The quoted market price of Kern's common stock was $45 per share on December 31, 1990.

- On April 1, 1990, Kern sold a patent to Frey Corp. in exchange for a $100,000 noninterest bearing note due on April 1, 1992. There was no established exchange price for the patent, and the note had no ready market. The prevailing interest rate for this type of note was 10% at April 1, 1990. The present value of $1 for two periods at 10% is 0.826. The patent had a carrying amount of $40,000 at January 1, 1990, and the amortization for the year ended December 31, 1990, would have been $8,000. Kern is reasonably assured of collecting the note receivable from Frey.

- On July 1, 1990, Kern sold a parcel of land to Barr Co. for $400,000 under an installment sale contract. Barr made a $120,000 cash down payment on July 1, 1990, and signed a four-year 10% note for the $280,000 balance. The equal annual payments of principal and interest on the note will be $88,332, payable on July 1 of each year from 1991 through 1994. The fair value of the land at the date of sale was $400,000. The cost of the land to Kern was $300,000. Collection of the remaining note installments is reasonably assured.

Required:

Prepare the following and show supporting computations:


b. Schedule showing current portion of long-term receivables and accrued interest receivable to be reported in Kern's December 31, 1990, balance sheet.

c. Schedule showing interest revenue from long-term receivables and gains recognized on sale of assets to be reported in Kern's 1990 income statement.
Cord Corp., a nonpublic enterprise, requires audited financial statements for credit purposes. After making normal adjusting entries, but before closing the accounting records for the year ended December 31, 1990, Cord's controller prepared the following financial statements for 1990:

**Cord Corp.**  
**STATEMENT OF FINANCIAL POSITION**  
**December 31, 1990**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,225,000</td>
</tr>
<tr>
<td>Marketable equity securities, at cost</td>
<td>125,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>460,000</td>
</tr>
<tr>
<td>Allowance for doubtful accounts</td>
<td>(55,000)</td>
</tr>
<tr>
<td>Inventories</td>
<td>530,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>620,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(280,000)</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$2,625,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders' Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>$1,685,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>110,000</td>
</tr>
<tr>
<td>Common stock, $20 par</td>
<td>300,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>75,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>455,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td>$2,625,000</td>
</tr>
</tbody>
</table>

**Cord Corp.**  
**STATEMENT OF INCOME**  
**For the Year Ended December 31, 1990**

| Net sales                                   | $1,700,000 |
| Operating expenses:                         |           |
| Cost of sales                               | 570,000   |
| Selling and administrative                  | 448,000   |
| Depreciation                                | 42,000    |
| **Total operating expenses**                | 1,060,000 |
| Income before income tax                    | 640,000   |
| Income tax expense                          | 192,000   |
| **Net income**                              | $ 448,000 |

Cord's tax rate for all income items was 30% for both 1990 and 1989, and it made estimated tax payments when due. After 1991, the enacted tax rate is 25%. During the course of the audit, the following additional information (not considered when the above statements were prepared) was obtained:

1. The investment portfolio consists of short-term investments for which total market value exceeded cost at December 31, 1989. On February 2, 1990, Cord sold one investment costing $100,000 for $130,000. The total of the sale proceeds was credited to the investment account.
Selected Questions

2. At December 31, 1990, the market value of the remaining securities in the portfolio was $142,000.

3. The $530,000 inventory total, which was based on a physical count at December 31, 1990, was priced at cost. Subsequently, it was determined that the inventory cost was overstated by $66,000. At December 31, 1990, the inventory's market value approximated the adjusted cost.

4. Pollution control devices costing $48,000, which is high in relation to the cost of the original equipment, were installed on December 29, 1989, and were charged to repairs in 1989.

5. The original equipment referred to in Item 4, which had a remaining useful life of six years on December 29, 1989, is being depreciated by the straight-line method for both financial and tax reporting.

6. A lawsuit was filed against Cord in October 1990 claiming damages of $250,000. Cord's legal counsel believes that an unfavorable outcome is probable, and a reasonable estimate of the court's award to the plaintiff is $60,000, which will be paid in 1992 if the case is settled.

7. Cord determined that its accumulated benefits obligation under the pension plan exceeded the fair value of plan assets by $40,000 at December 31, 1990. Cord has unrecognized prior service cost of $50,000 at December 31, 1990. Cord funds the total pension expense each year.

Required:
Prepare journal entries, without explanations, to record the effects of the foregoing data on Cord's accounting records at December 31, 1990. Do not prepare corrected financial statements for 1990. The journal entries should be numbered to correspond with the numbers in the additional information. Include as the last entry any necessary adjustments to the 1990 income tax expense, and support your computations for this entry.

1N90
Number 4 (Estimated time — 45 to 55 minutes)

Presented below is the unaudited balance sheet as of December 31, 1989, prepared by the bookkeeper of Zues Manufacturing Corp.

Zues Manufacturing Corp.
BALANCE SHEET
For the Year Ended December 31, 1989

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Stockholders' Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>$ 225,000</td>
<td>$ 133,800</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>Mortgage payable</td>
</tr>
<tr>
<td>345,700</td>
<td>900,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>Notes payable</td>
</tr>
<tr>
<td>560,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Prepaid income taxes</td>
<td>Lawsuit liability</td>
</tr>
<tr>
<td>40,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Investments</td>
<td>Income taxes payable</td>
</tr>
<tr>
<td>57,700</td>
<td>61,200</td>
</tr>
<tr>
<td>Land</td>
<td>Deferred tax liability</td>
</tr>
<tr>
<td>450,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Building</td>
<td>Accumulated depreciation</td>
</tr>
<tr>
<td>1,750,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>Total liabilities</td>
</tr>
<tr>
<td>1,964,000</td>
<td>$2,123,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>Total stockholders' equity</td>
</tr>
<tr>
<td>37,000</td>
<td>$3,306,400</td>
</tr>
<tr>
<td>Total assets</td>
<td>Total liabilities and stockholders' equity</td>
</tr>
<tr>
<td>$5,429,400</td>
<td>$5,429,400</td>
</tr>
</tbody>
</table>

AP-155
Your firm has been engaged to perform an audit, during which the following data are found:

- Checks totaling $14,000 in payment of accounts payable were mailed on December 30, 1989 but were not recorded until 1990. Late in December 1989, the bank returned a customer's $2,000 check, marked "NSF," but no entry was made. Cash includes $100,000 restricted for building purposes.

- Included in accounts receivable is a $30,000 note due on December 31, 1992 from Zues' president.

- During 1989, Zues purchased 500 shares of common stock of a major corporation that supplies Zues with raw materials. Total cost of this stock was $51,300, and market value on December 31, 1989 was $47,000. The decline in market value is considered temporary. Zues plans to hold these shares indefinitely.

- Treasury stock was recorded at cost when Zues purchased 200 of its own shares for $32 per share in May 1989. This amount is included in investments.

- On December 30, 1989, Zues borrowed $500,000 from a bank in exchange for a 10% note payable, maturing December 30, 1994. Equal principal payments are due December 30 of each year, beginning in 1990. This note is collateralized by a $250,000 tract of land acquired as a potential future building site, which is included in land.

- The mortgage payable requires $50,000 principal payments, plus interest, at the end of each month.

Payments were made on January 31 and February 28, 1990. The balance of this mortgage was due June 30, 1990. On March 1, 1990, prior to issuance of the audited financial statements, Zues consummated a noncancelable agreement with the lender to refinance this mortgage. The new terms require $100,000 annual principal payments, plus interest, on February 28 of each year, beginning in 1991. The final payment is due February 28, 1998.

- The lawsuit liability will be paid in 1990.

- Zues elected early application of FASB Statement No. 96, Accounting for Income Taxes.

The following is an analysis of the deferred tax liability at December 31, 1989:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred taxes related to depreciation</td>
<td>$48,000</td>
</tr>
<tr>
<td>Deferred taxes related to a lawsuit liability</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Net deferred tax liability</td>
<td>$28,000</td>
</tr>
</tbody>
</table>

$25,000 of the deferred taxes related to depreciation will reverse in 1990.

- The current income tax expense reported in Zues' 1989 income statement was $61,200.

- The company was authorized to issue 100,000 shares of $50 par value common stock.

Required:
Prepare a corrected classified balance sheet as of December 31, 1989. This financial statement should include a proper heading, format and necessary descriptions.
Selected Questions

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:

Cox Stationery Supply
TRIAL BALANCE
December 31, 1986

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$16,500</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>39,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>52,500</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$20,500</td>
</tr>
<tr>
<td>Note payable, bank</td>
<td>10,000</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>1,300</td>
</tr>
<tr>
<td>Cox, capital</td>
<td>76,200</td>
</tr>
<tr>
<td>$108,000</td>
<td>$108,000</td>
</tr>
</tbody>
</table>

During the last quarter of 1986, John Cox and Mary Rice, an outside investor, agreed to incorporate the business under the name of Cox Stationers, Inc. Cox will receive 1,000 shares for his business, and Rice will pay $86,000 cash for her 1,000 shares. On January 1, 1987, they received the certificate of incorporation for Cox Stationers, Inc., and the corporation issued 1,000 shares of common stock each to Cox and Rice for the above consideration. The agreement between Cox and Rice requires that the December 31, 1986 balance sheet of the proprietorship should be converted to the accrual basis, with all assets and liabilities stated at current fair values, including Cox’s goodwill implicit in the terms of the common stock issuance.

Additional information:

1. Amounts due from customers totaled $23,500 at December 31, 1986. A review of collectibility disclosed that an allowance for doubtful accounts of $3,300 is required.

2. The $39,000 merchandise inventory is based on a physical count of goods priced at cost. Unsalable damaged goods costing $2,500 are included in the count. The current fair value of the total merchandise inventory is $45,000.

3. On July 1, 1986, Cox paid $3,800 to renew the comprehensive insurance coverage for one year.

4. The $10,000 note payable is dated July 1, 1986, bears interest at 12%, and is due July 1, 1987.


6. During January 1987, final payroll tax returns filed for Cox Stationery Supply required remittances totaling $2,100.

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.
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," for all examination questions prior to May 1989. All subsequent examination questions and unofficial answers relating to accounting for income taxes are and will be based on SFAS No. 96.

Number 4 (Estimated time — — 45 to 55 minutes)

Before closing the books for the year ended December 31, 1988, Pitt Corp. prepared the following condensed trial balance:

Condensed Trial Balance
December 31, 1988

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$ 7,082,500</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$ 1,700,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>2,097,500</td>
</tr>
<tr>
<td>Donated capital</td>
<td>90,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/88</td>
<td>1,650,000</td>
</tr>
<tr>
<td>Net sales</td>
<td>6,250,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>3,750,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>1,212,500</td>
</tr>
<tr>
<td>Interest expense</td>
<td>122,500</td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td>130,000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>300,000</td>
</tr>
<tr>
<td>Loss on disposition of plant assets</td>
<td>225,000</td>
</tr>
<tr>
<td>Loss due to earthquake damage</td>
<td>475,000</td>
</tr>
<tr>
<td></td>
<td>$13,167,500</td>
</tr>
<tr>
<td></td>
<td>$13,167,500</td>
</tr>
</tbody>
</table>

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

Federal income tax

- Estimated tax payments $200,000
- Accrued 100,000

Total charged to income tax expense (Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.) $300,000

Pitt elected to apply the provisions of FASB Statement No. 96, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1988. The enacted tax rate on all types of taxable income for the current and future years is 30%. The alternative minimum tax is less than the regular income tax.
Selected Questions

Temporary difference
Excess of book basis over tax basis in depreciable assets (arising from equipment donated as a capital contribution on December 31, 1988 and expected to be depreciated over five years beginning in 1989). There were no temporary differences prior to 1988. $90,000

Non-deductible expenditure
Officers' life insurance expense $70,000

Earthquake damage
This damage is considered unusual and infrequent.

Capital structure
Common stock, par value $5 per share, traded on a national exchange:

<table>
<thead>
<tr>
<th>Number of shares:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding at 1/1/88</td>
<td>200,000</td>
</tr>
<tr>
<td>Issued on 3/30/88 as a 10% stock dividend</td>
<td>20,000</td>
</tr>
<tr>
<td>Sold for $25 per share on 6/30/88</td>
<td>30,000</td>
</tr>
<tr>
<td>Outstanding at 12/31/88</td>
<td>250,000</td>
</tr>
</tbody>
</table>

Required:

a. Using the multiple-step format, prepare a formal income statement for Pitt for the year ended December 31, 1988.

b. Prepare a schedule to reconcile net income to taxable income reportable on Pitt's tax return for 1988.
The following information pertains to Arlon Corporation:

**TRIAL BALANCE**  
December 31, 1987

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>75,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>125,000</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>755,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$239,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>70,000</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>6,000</td>
</tr>
<tr>
<td>Rental revenue received in advance</td>
<td>5,000</td>
</tr>
<tr>
<td>Notes payable</td>
<td>55,000</td>
</tr>
<tr>
<td>Common stock, $.05 par</td>
<td>50,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>305,000</td>
</tr>
<tr>
<td>Retained earnings, 1/1/87</td>
<td>150,000</td>
</tr>
<tr>
<td>Sales — regular</td>
<td>500,000</td>
</tr>
<tr>
<td>Sales — Mem Division</td>
<td>100,000</td>
</tr>
<tr>
<td>Proceeds from term life insurance policy</td>
<td>10,000</td>
</tr>
<tr>
<td>Cost of sales — regular</td>
<td>310,000</td>
</tr>
<tr>
<td>Cost of sales — Mem Division</td>
<td>45,000</td>
</tr>
<tr>
<td>Administrative expenses — regular</td>
<td>103,000</td>
</tr>
<tr>
<td>Administrative expenses — Mem Division</td>
<td>15,000</td>
</tr>
<tr>
<td>Interest expense — regular</td>
<td>10,500</td>
</tr>
<tr>
<td>Interest expense — Mem Division</td>
<td>7,000</td>
</tr>
<tr>
<td>Loss on disposal of Mem Division</td>
<td>12,500</td>
</tr>
<tr>
<td>Gain on acquisition of bonds payable</td>
<td>13,000</td>
</tr>
</tbody>
</table>
| Income tax expense | 20,000  
| Totals       | $1,503,000   |

**Other Information**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income tax</strong></td>
<td></td>
</tr>
<tr>
<td>Paid with Federal Tax Deposit Forms</td>
<td>$14,000</td>
</tr>
<tr>
<td>Accrued</td>
<td>6,000</td>
</tr>
<tr>
<td>Total charged to income tax expense</td>
<td>$20,000*</td>
</tr>
</tbody>
</table>

*Does not reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

- Income per income tax return $99,000
- Tax rate on all types of taxable income 22%
- Depreciation per financial statements — regular $30,000
- Depreciation per income tax return 46,000 $16,000
- Rental revenue received in advance 5,000

**Permanent difference**
Proceeds from term life insurance policy 10,000

**Discontinued operations**
On June 30, 1987, Arlon sold its Mem Division for $200,000. The carrying amount of this business segment was $212,500 at that date. This sale was considered as a disposal of a segment of a business for financial statement purposes. Since there was no phaseout period, the measurement date was June 30, 1987.

**Liabilities**
On June 30, 1987, Arlon acquired $100,000 carrying amount of its long-term bonds for $87,000. All other liabilities mature in 1988.

**Capital structure**
Common stock, $.05 par, traded over-the-counter; 1,000,000 shares issued and outstanding at 1/1/87 and 12/31/87.

**Required:**
Using the multiple-step format, prepare a formal income statement for Arlon for the year ended December 31, 1987, together with supporting computations of current and deferred income taxes and of income from discontinued operations.
C. Statement of Cash Flows

1989
Number 5 (Estimated time — 40 to 50 minutes)

Presented below are the condensed statements of financial position of Linden Consulting Associates as of December 31, 1989 and 1988, and the condensed statement of income for the year ended December 31, 1989.

Linden Consulting Associates
CONDENSED STATEMENTS OF FINANCIAL POSITION
December 31, 1989 and 1988

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1988</th>
<th>Net change increase (decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$652,000</td>
<td>$280,000</td>
<td>$372,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>446,000</td>
<td>368,000</td>
<td>78,000</td>
</tr>
<tr>
<td>Investment in Zach, Inc., at equity</td>
<td>550,000</td>
<td>466,000</td>
<td>84,000</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>1,270,000</td>
<td>1,100,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(190,000)</td>
<td>(130,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Excess of cost over book value of investment in Zach, Inc. (net)</td>
<td>152,000</td>
<td>156,000</td>
<td>(4,000)</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$2,880,000</td>
<td>$2,240,000</td>
<td>$640,000</td>
</tr>
</tbody>
</table>

| **Liabilities and Partners' Equity** |          |          |                                |
| Accounts payable and accrued expenses | $320,000 | $270,000 | $50,000 |
| Mortgage payable                 | 250,000  | 270,000  | (20,000) |
| Partners' equity                 | 2,310,000 | 1,700,000 | 610,000 |
| **Total liabilities and partners' equity** | $2,880,000 | $2,240,000 | $640,000 |

Linden Consulting Associates
CONDENSED STATEMENT OF INCOME
For the Year Ended December 31, 1989

Fee revenue                        | $2,664,000 |
Operating expenses                 | 1,940,000  |
Operating income                   | 724,000    |
Equity in earnings of Zach, Inc. (net of $4,000 amortization of excess of cost over book value) | 176,000 |
Net income                         | $900,000   |

Additional information:

- On December 31, 1988, partners' capital and profit sharing percentages were as follows:

<table>
<thead>
<tr>
<th>Capital</th>
<th>Profit sharing %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Garr</td>
<td>$1,020,000</td>
</tr>
<tr>
<td>Pat</td>
<td>680,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,700,000</td>
</tr>
</tbody>
</table>

AP-161
On January 1, 1989, Garr and Pat admitted Scott to the partnership for a cash payment of $340,000 to Linden Consulting Associates as the agreed amount of Scott’s beginning capital account. In addition, Scott paid a $50,000 cash bonus directly to Garr and Pat. This amount was divided $30,000 to Garr and $20,000 to Pat. The new profit sharing arrangement is as follows:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Garr</td>
<td>50%</td>
<td>Pat</td>
<td>30%</td>
</tr>
<tr>
<td>Scott</td>
<td>20%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

On October 1, 1989, Linden purchased and paid for an office computer costing $170,000, including $15,000 for sales tax, delivery, and installation. There were no dispositions of property and equipment during 1989.

Throughout 1989, Linden owned 25% of Zach, Inc.’s common stock. As a result of this ownership interest, Linden can exercise significant influence over Zach’s operating and financial policies. During 1989, Zach paid dividends totaling $384,000 and reported net income of $720,000. Linden’s 1989 amortization of excess of cost over book value in Zach was $4,000.

Partners’ drawings for 1989 were as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Garr</td>
<td>$280,000</td>
</tr>
<tr>
<td>Pat</td>
<td>200,000</td>
</tr>
<tr>
<td>Scott</td>
<td>150,000</td>
</tr>
</tbody>
</table>

$630,000

Required:


b. Prepare a reconciliation of net income to net cash provided by operating activities.

c. Prepare an analysis of changes in partners’ capital accounts for the year ended December 31, 1989.
Presented below are the balance sheet accounts of Kern, Inc. as of December 31, 1988 and 1987 and their net changes.

### Assets

<table>
<thead>
<tr>
<th></th>
<th>1988</th>
<th>1987</th>
<th>Net change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$471,000</td>
<td>$307,000</td>
<td>$164,000</td>
</tr>
<tr>
<td>Marketable equity securities, at cost</td>
<td>150,000</td>
<td>250,000</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Allowance to reduce marketable equity securities to market</td>
<td>(10,000)</td>
<td>(25,000)</td>
<td>15,000</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>550,000</td>
<td>515,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>810,000</td>
<td>890,000</td>
<td>(80,000)</td>
</tr>
<tr>
<td>Investment in Word Corp., at equity</td>
<td>420,000</td>
<td>390,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,145,000</td>
<td>1,070,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(345,000)</td>
<td>(280,000)</td>
<td>(65,000)</td>
</tr>
<tr>
<td>Patent, net</td>
<td>109,000</td>
<td>118,000</td>
<td>(9,000)</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$3,300,000</td>
<td>$3,235,000</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

### Liabilities and Stockholders' Equity

<table>
<thead>
<tr>
<th></th>
<th>1988</th>
<th>1987</th>
<th>Net change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>$845,000</td>
<td>$960,000</td>
<td>(115,000)</td>
</tr>
<tr>
<td>Note payable, long-term</td>
<td>600,000</td>
<td>900,000</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>190,000</td>
<td>190,000</td>
<td>—</td>
</tr>
<tr>
<td>Common stock, $10 par value</td>
<td>850,000</td>
<td>650,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>230,000</td>
<td>170,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>585,000</td>
<td>365,000</td>
<td>220,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' equity</strong></td>
<td>$3,300,000</td>
<td>$3,235,000</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

### Additional information:

- On January 2, 1988, Kern sold equipment costing $45,000, with a carrying amount of $28,000, for $18,000 cash.
- On March 31, 1988, Kern sold one of its marketable equity security holdings for $119,000 cash. There were no other transactions involving marketable equity securities.
- On April 15, 1988, Kern issued 20,000 shares of its common stock for cash at $13 per share.
- On July 1, 1988, Kern purchased equipment for $120,000 cash.
- Kern's net income for 1988 is $305,000. Kern paid a cash dividend of $85,000 on October 26, 1988.
- Kern acquired a 20% interest in Word Corp.'s common stock during 1985. There was no goodwill attributable to the investment which is appropriately accounted for by the equity method. Word reported net income of $150,000 for the year ended December 31, 1988. No dividend was paid on Word's common stock during 1988.

### Required:

Prepare a statement of cash flows for Kern, Inc. for the year ended December 31, 1988 using the indirect method. A worksheet is not required.
D. Statement of Owners’ Equity

1M90
Number 5 (Estimated time — — 40 to 50 minutes)

Mart, Inc., is a public company whose shares are traded in the over-the-counter market. At December 31, 1988, Mart had 6,000,000 authorized shares of $5 par value common stock, of which 2,000,000 shares were issued and outstanding. The stockholders’ equity accounts at December 31, 1988 had the following balances:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>7,500,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,250,000</td>
</tr>
</tbody>
</table>

Transactions during 1989 and other information relating to the stockholders’ equity accounts were as follows:

- On January 5, 1989, Mart issued at $54 per share, 100,000 shares of $50 par value, 9% cumulative, convertible preferred stock. Each share of preferred stock is convertible, at the option of the holder, into two shares of common stock. Mart had 250,000 authorized shares of preferred stock. The preferred stock has a liquidation value of $55 per share.

- On February 1, 1989, Mart reacquired 20,000 shares of its common stock for $16 per share. Mart uses the cost method to account for treasury stock.

- On March 15, 1989, Mart paid $200,000 for 10,000 shares of common stock of Lew, Inc., a public company whose stock is traded on a national stock exchange. This stock was acquired for long-term investment purposes and had a fair market value of $15 per share on December 31, 1989. This decline in market value was not considered permanent.

- On April 30, 1989, Mart had completed an additional public offering of 500,000 shares of its $5 par value common stock. The stock was sold to the public at $12 per share, net of offering costs.

- On June 17, 1989, Mart declared a cash dividend of $1 per share of common stock, payable on July 10, 1989 to stockholders of record on July 1, 1989.

- On November 6, 1989, Mart sold 10,000 shares of treasury stock for $21 per share.


- On January 17, 1990, before the books were closed for 1989, Mart became aware that the ending inventories at December 31, 1988 were overstated by $200,000. The after-tax effect on 1988 net income was $140,000. The appropriate correction entry was recorded the same day.

- After correction of the beginning inventories, net income for 1989 was $2,250,000.

Required:

a. Prepare a statement of retained earnings for the year ended December 31, 1989. Assume that only single period financial statements for 1989 are presented.

b. Prepare the stockholders’ equity section of Mart’s balance sheet at December 31, 1989.

Selected Questions

E. Consolidated Financial Statements or Worksheets

1M80
Number 4 (Estimated time — — 45 to 55 minutes)

Cain Corp. acquired all of the outstanding $10 par value voting common stock of Frey, Inc. on January 1, 1989 in exchange for 25,000 shares of its $10 par value voting common stock. On December 31, 1988, Cain’s common stock had a closing market price of $30 per share on a national stock exchange. The acquisition was appropriately accounted for as a purchase. Both companies continued to operate as separate business entities maintaining separate accounting records with years ending December 31.

On December 31, 1989, the companies had condensed financial statements as follows:

<table>
<thead>
<tr>
<th>Cain Corp.</th>
<th>Frey, Inc.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Statement</strong></td>
<td></td>
</tr>
<tr>
<td>Net sales</td>
<td>$(3,800,000)</td>
</tr>
<tr>
<td>Dividends from Frey</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>2,560,000</td>
</tr>
<tr>
<td>Operating expenses (including depreciation)</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ (410,000)</td>
</tr>
</tbody>
</table>

| **Retained Earnings Statement** | | |
| Balance, 1/1/89 | $ (440,000) | $(156,000) |
| Net income | (410,000) | (190,000) |
| Dividends paid | 40,000 | |
| Balance, 12/31/89 | $ (850,000) | $(306,000) |

| **Balance Sheet** | | |
| Assets: | | |
| Cash | $ 570,000 | $ 150,000 |
| Accounts receivable (net) | 860,000 | 350,000 |
| Inventories | 1,060,000 | 410,000 |
| Land, plant and equipment | 1,320,000 | 680,000 |
| Accumulated depreciation | (370,000) | (210,000) |
| Investment in Frey (at cost) | 750,000 | |
| Total Assets | $ 4,190,000 | $ 1,380,000 |

Liabilities & Stockholders’ Equity:

| Accounts payable & accrued expenses | $(1,340,000) | $(594,000) |
| Common stock ($10 par) | (1,700,000) | (400,000) |
| Additional paid-in capital | (300,000) | (80,000) |
| Retained earnings | (850,000) | (306,000) |
| **Total Liabilities & Stockholders’ Equity** | $(4,190,000) | $(1,380,000) |

Additional information follows:

- There were no changes in the common stock and additional paid-in capital accounts during 1989 except the one necessitated by Cain’s acquisition of Frey.

- At the acquisition date, the fair value of Frey’s machinery exceeded its book value by $54,000. The excess cost will be amortized over the estimated average remaining life of six years. The fair values of all of Frey’s other assets and liabilities were equal to their book values. Any goodwill resulting from the acquisition will be amortized over a 20-year period.

- On July 1, 1989, Cain sold a warehouse facility to Frey for $129,000 cash. At the date of sale, Cain’s book values were $33,000 for the land and $66,000 for the undepreciated cost of the building. Based on a real estate appraisal, Frey allocated $43,000 of the purchase price to land and $86,000 to building. Frey is depreciating the building over its estimated five-year remaining useful life by the straight-line method with no salvage value.

- During 1989, Cain purchased merchandise from Frey at an aggregate invoice price of $180,000, which included a 100% markup on Frey’s cost. At December 31, 1989, Cain owed Frey $86,000 on these purchases, and $36,000 of this merchandise remained in Cain’s inventory.

**Required:** Detach the tear-out worksheet on page AP-166.

Complete the tear-out worksheet that would be used to prepare a consolidated income statement and a consolidated retained earnings statement for the year ended December 31, 1989, and a consolidated balance sheet as of December 31, 1989. Formal consolidated statements and adjusting entries are not required. Ignore income tax considerations. Supporting computations should be in good form. Include the completed tear-out worksheet in the proper sequence and include it with the other answer sheets.
**CONSOLIDATING STATEMENT WORKSHEET**
*December 31, 1989*

### Income Statement

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Dr. (Cr.)</th>
<th>Frey, Inc. Dr. (Cr.)</th>
<th>Adjustments &amp; Eliminations Dr.</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>(3,800,000)</td>
<td>(1,500,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends from Frey</td>
<td>(40,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>2,360,000</td>
<td>870,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses (including depreciation)</td>
<td>1,100,000</td>
<td>440,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>(410,000)</td>
<td>(190,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Retained Earnings Statement

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 1/1/89</td>
<td>(440,000)</td>
<td>(156,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>(410,000)</td>
<td>(190,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance, 12/31/89</td>
<td>(850,000)</td>
<td>(306,000)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Cr. (Dr.)</th>
<th>Frey, Inc. Cr. (Dr.)</th>
<th>Cain Corp. Cr. (Dr.)</th>
<th>Frey, Inc. Cr. (Dr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>570,000</td>
<td>150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>860,000</td>
<td>350,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>1,060,000</td>
<td>410,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land, plant and equipment</td>
<td>1,320,000</td>
<td>680,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(370,000)</td>
<td>(210,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in Frey (at cost)</td>
<td>750,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td>4,190,000</td>
<td>1,380,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Liabilities & Stockholders' Equity: |                      |                      |                      |                      |
| Accounts payable & accrued expenses | (1,340,000)          | (594,000)            |                      |                      |
| Common stock ($10 par) | (1,700,000)           | (400,000)            |                      |                      |
| Additional paid-in capital | (300,000)            | (80,000)             |                      |                      |
| Retained earnings     | (850,000)              | (306,000)            |                      |                      |
| Total Liabilities & Stockholders' Equity | (4,190,000)         | (1,380,000)          |                      |                      |

AP-166
Selected Questions

1N88
Number 5 (Estimated time — 40 to 50 minutes)


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>865,000</td>
<td>385,000</td>
</tr>
<tr>
<td>and other assets</td>
<td></td>
<td></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>

| Liabilities and          | Peel          | Stagg         |
| Stockholders' Equity:    |               |               |
| Accounts payable and     | $2,465,000    | $1,145,000    |
| other current liabilities|               |               |
| 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     |
| **Total liabilities**    | **$13,795,000**| **$4,875,000**|

Additional information is as follows:

- 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></th>
<th>Peel</th>
<th>Stagg</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>$6,896,000</td>
<td>$2,170,000</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 AP-168 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>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></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>$13,795,000 $4,875,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and stockholders' equity:</th>
<th>Peel, Inc.</th>
<th>Stagg, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated Balance</th>
</tr>
</thead>
<tbody>
<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>
</tbody>
</table>

|                                  | $13,795,000 | $4,875,000 |                             |                      |

AP-168
Selected Questions

2N87
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.
### CONSOLIDATED BALANCE SHEET WORKSHEET

#### Pym Corp. and Subsidiary

**December 31, 1986**

<table>
<thead>
<tr>
<th></th>
<th>Pym Corp.</th>
<th>Sy Corp.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>75,000</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts and other</td>
<td>410,000</td>
<td>120,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>current receivables</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>
</tr>
<tr>
<td>Plant and equipment</td>
<td>1,000,000</td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(net)</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>
</tr>
<tr>
<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>
</tr>
<tr>
<td><strong>Liabilities and</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Stockholders’ Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and</td>
<td>140,000</td>
<td>305,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>other current</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>500,000</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,965,000</td>
<td>700,000</td>
<td></td>
<td></td>
</tr>
<tr>
<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>
</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

1M89
Number 5 (Estimated time — — 40 to 50 minutes)

At December 31, 1987, Poe Corp. properly reported as current assets the following marketable equity securities:

<table>
<thead>
<tr>
<th>Security</th>
<th>Shares/Amount</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axe Corp.</td>
<td>1,000 shares, $2.40</td>
<td>$40,000</td>
</tr>
<tr>
<td>convertible preferred stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purl Inc.</td>
<td>6,000 shares of common stock</td>
<td>60,000</td>
</tr>
<tr>
<td>Day Co.</td>
<td>2,000 shares of common stock</td>
<td>55,000</td>
</tr>
<tr>
<td>Marketable equity securities at cost</td>
<td>155,000</td>
<td></td>
</tr>
<tr>
<td>Less valuation allowance</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Marketable equity securities at market value</td>
<td>$148,000</td>
<td></td>
</tr>
</tbody>
</table>

On January 2, 1988, Poe purchased 100,000 shares of Scott Corp. common stock for $1,700,000, representing 30% of Scott’s outstanding common stock and an underlying equity of $1,400,000 in Scott’s net assets on January 2. Poe, which had no other financial transactions with Scott during 1988, amortizes goodwill over a 40-year period. As a result of Poe’s 30% ownership of Scott, Poe has the ability to exercise significant influence over Scott’s financial and operating policies.

During 1988, Poe disposed of the following securities:

- January 18 — sold 2,500 shares of Purl for $13 per share.
- June 1 — sold 500 shares of Day, after a 10% stock dividend was received, for $21 per share.
- October 1 — converted 500 shares of Axe’s preferred stock into 1,500 shares of Axe’s common stock, when the market price was $60 per share for the preferred stock and $21 per share for the common stock.

The following 1988 dividend information pertains to stock owned by Poe:

- February 14 — Day issued a 10% stock dividend, when the market price of Day’s common stock was $22 per share.
- April 5 and October 5 — Axe paid dividends of $1.20 per share on its $2.40 preferred stock, to stockholders of record on March 9 and September 9, respectively. Axe did not pay dividends on its common stock during 1988.
- June 30 — Purl paid a $1.00 per share dividend on its common stock.
- March 1, June 1, September 1, and December 1 — Scott paid quarterly dividends of $0.50 per share on each of these dates. Scott’s net income for the year ended December 31, 1988 was $1,200,000.

At December 31, 1988, Poe’s management intended to hold Scott’s stock as a long-term investment, with the remaining investments being considered as temporary. Market prices per share of the marketable equity securities were as follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>1988</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axe Corp. — preferred</td>
<td>$56</td>
<td>$42</td>
</tr>
<tr>
<td>Axe Corp. — common</td>
<td>20</td>
<td>18</td>
</tr>
<tr>
<td>Purl, Inc. — common</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Day Co. — common</td>
<td>22</td>
<td>20</td>
</tr>
<tr>
<td>Scott Corp. — common</td>
<td>16</td>
<td>18</td>
</tr>
</tbody>
</table>

All of the foregoing stocks are listed on major stock exchanges. Declines in market value from cost would not be considered permanent.

Required:

a. Prepare a schedule of Poe’s current marketable equity securities at December 31, 1988, including any information necessary to determine the related valuation allowance and unrealized gains and losses.

b. Prepare a schedule to show the carrying amount of Poe’s noncurrent marketable equity securities at December 31, 1988.

c. Prepare a schedule showing all revenue, gains, and losses (realized and unrealized) relating to Poe’s investments for the year ended December 31, 1988.
B. Receivables and Accruals

1M88
Number 5 (Estimated time — — 40 to 50 minutes)

Among the account balances of Rowe Corp. at December 31, 1986, are the following:

Patent, net of accumulated patent amortization $245,000
Installment contract receivable, including current portion 720,000

In its year-end financial statements, Rowe reports as other noncurrent assets all assets that are not classified as property, plant, and equipment or as current assets. Relevant transactions and other information for 1987 were as follows:

- The patent was purchased from Lake Co. for $315,000 on September 1, 1983. On that date the remaining legal life was 15 years, which was also determined to be the useful life.

- The installment contract receivable represents the balance of the consideration received from the sale of a factory building to Pitt Co. on March 31, 1985, for $1,200,000. Pitt made a $300,000 down payment and signed a five-year 13% note for the $900,000 balance. The first of equal annual principal payments of $180,000 was received on March 31, 1986, together with interest to that date. The note is collateralized by the factory building with a fair value of $1,000,000 at December 31, 1986, and December 31, 1987. The 1987 payment was received on time.

- On January 2, 1987, Rowe purchased a trademark from Kerr Corp. for $250,000. Rowe considers the life of the trademark to be indefinite. The trademark will be amortized over the maximum period allowable.

- On May 1, 1987, Rowe sold the patent to Strand Co. in exchange for a $500,000 noninterest bearing note due on May 1, 1990. There was no established exchange price for the patent, and the note had no ready market. The prevailing rate of interest for a note of this type at May 1, 1987 was 14%. The present value of I 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>Income</th>
<th>Dividends per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Six months ended 6/30/87</td>
<td>$576,000</td>
</tr>
<tr>
<td>Six months ended 12/31/87</td>
<td>704,000</td>
</tr>
<tr>
<td>(Dividend was paid 11/30/87)</td>
<td></td>
</tr>
</tbody>
</table>

- 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.
Selected Questions

D. Property, Plant, and Equipment Owned or Leased

1N89
Number 4 (Estimated time — — 45 to 55 minutes)

Nan Co.'s property, plant, and equipment and accumulated depreciation and amortization balances at December 31, 1987 are:

<table>
<thead>
<tr>
<th>Depreciation Methods and Useful Lives</th>
<th>Cost</th>
<th>Accumulated Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 275,000</td>
<td>—</td>
</tr>
<tr>
<td>Buildings</td>
<td>2,800,000</td>
<td>$ 672,900</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,380,000</td>
<td>367,500</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>210,000</td>
<td>114,326</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>432,000</td>
<td>108,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,097,000</td>
<td>$1,262,726</td>
</tr>
</tbody>
</table>

Additional information follows:

Depreciation and amortization methods and useful lives

Buildings — 150% declining balance; 25 years.
Machinery and equipment — straight-line; 10 years.
Automobiles and trucks — 150% declining balance; five years, all acquired after 1985.
Leasehold improvements — straight-line.
Depreciation is computed to the nearest month.

Salvage values of depreciable assets are immaterial except for automobiles and trucks which have estimated salvage values equal to 15% of cost.

Other additional information

- Nan entered into a twelve-year operating lease starting January 1, 1985. The leasehold improvements were completed on December 31, 1984 and the facility was occupied on January 1, 1985.

- On January 6, 1988, Nan completed its self-constructed building on its own land. Direct costs of construction were $1,095,000. Construction of the building required 15,000 direct labor hours. Nan's construction department has an overhead allocation system for outside jobs based on an activity denominator of 100,000 direct labor hours, budgeted fixed costs of $2,500,000, and budgeted variable costs of $27 per direct labor hour.

- On July 1, 1988, machinery and equipment were purchased at a total invoice cost of $325,000. Additional costs of $23,000 to rectify damage on delivery and $18,000 for concrete embedding of machinery were incurred. A wall had to be demolished to enable a large machine to be moved into the plant. The wall demolition cost $7,000, and rebuilding of the wall cost $19,000.

- On August 30, 1988, Nan purchased a new automobile for $25,000.

- On September 30, 1988, a truck with a cost of $48,000 and a carrying amount of $30,000 on December 31, 1987 was sold for $23,500.

- On November 4, 1988, Nan purchased a tract of land for investment purposes for $700,000. Nan thinks it might use the land as a potential future building site.

- On December 20, 1988, a machine with a cost of $17,000, a carrying amount of $2,975 on date of disposition, and a market value of $4,000 was given to a corporate officer in partial liquidation of a debt.

Required: Detach the tear-out worksheet on page AP-174.

a. Analyze the changes in each of the property, plant, and equipment accounts during 1988 by completing Schedule No. 1.

b. 1. For each asset category, prepare a schedule showing calculations for depreciation or amortization expense for the year ended December 31, 1988. Round computations to the nearest whole dollar.

2. Analyze the changes in accumulated depreciation and amortization by completing Schedule No. 2.

 c. Prepare a schedule showing gain or loss on disposition of property, plant, and equipment.
a.

Schedule 1

Nan Co.
ANALYSIS OF CHANGES IN PROPERTY, PLANT, AND EQUIPMENT
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/87</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$275,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>2,800,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,380,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>210,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>432,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$5,097,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

b. 2.

Schedule 2

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/87</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>$672,900</td>
<td>367,500</td>
<td></td>
<td>$1,040,400</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>114,326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>108,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>108,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$1,262,726</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Selected Questions

1N88

Number 4 (Estimated time — — 45 to 55 minutes)

At December 31, 1986, Cord Company’s plant asset and accumulated depreciation and amortization accounts had balances as follows:

<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.


- 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.

1N87

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>Plant asset</th>
<th>Accumulated depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$350,000</td>
</tr>
<tr>
<td>Land improve</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.

AP-175
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.

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

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.
Selected Questions

1M88
Number 4 (Estimated time — 45 to 55 minutes)

Fay, Inc. finances its capital needs approximately one-third from long-term debt and two-thirds from equity. At December 31, 1986, Fay had the following liability and equity account balances:

11% Debenture bonds payable,
face amount $5,000,000
Premium on bonds payable 352,400
Common stock 8,000,000
Additional paid-in capital 2,295,000
Retained earnings 2,465,000
Treasury stock, at cost 325,000

Transactions during 1987 and other information relating to Fay’s liabilities and equity accounts were as follows:

- The debenture bonds were issued on December 31, 1984, for $5,378,000 to yield 10%. The bonds mature on December 31, 1999. Interest is payable annually on December 31. Fay uses the interest method to amortize bond premium.

- Fay’s common stock shares are traded on the over-the-counter market. At December 31, 1986, Fay had 2,000,000 authorized shares of $10 par common stock.

- On January 15, 1987, Fay reissued 15,000 of its 25,000 shares of treasury stock for $225,000. The treasury stock had been acquired on February 28, 1986.

- On March 2, 1987, Fay issued a 5% stock dividend on all issued shares. The market price of Fay’s common stock at time of issuance was $14 per share.

- On November 1, 1987, Fay borrowed $4,000,000 at 9%, evidenced by an unsecured note payable to United Bank. The note is payable in five equal annual principal installments of $800,000. The first principal and interest payment is due on November 1, 1988.

- On December 31, 1987, Fay owned 10,000 shares of Ryan Corp.’s common stock, which represented a 1% ownership interest. Fay accounts for this marketable equity investment as a long-term investment. The stock was purchased on May 1, 1986, at $20 per share. The market price was $21 per share on December 31, 1986, and $18 per share on December 31, 1987.

- Fay’s net income for 1987 was $2,860,000.

Required (Include formal schedules of supporting computations with each item referenced to correspond with the items in the solution):

a. Prepare the long-term liabilities section of Fay’s December 31, 1987 balance sheet, including all disclosures applicable to each obligation.

b. Prepare the stockholders’ equity section of Fay’s December 31, 1987 balance sheet.

c. Prepare a schedule showing interest expense for the year ended December 31, 1987.

VII. Cost Accumulation, Planning, and Control

2M91
Number 5 (Estimated time — 40 to 50 minutes)

Spara Corp. is considering the various benefits that may result from the shortening of its product cycle by changing from the company’s present manual system to a computer-aided design/computer-aided manufacturing (CAD/CAM) system. The proposed system can provide productive time equivalency close to the 20,000 hours currently available with the manual system. The incremental annual out-of-pocket costs of maintaining the manual system are $20 per hour.

The incremental annual out-of-pocket costs of maintaining the CAD/CAM system are estimated to be $200,000, with an initial investment of $480,000 in the proposed system. The estimated useful life of this system is six years. For tax purposes, assume a level accelerated cost recovery with a full year allowable in each year. The tax rate is expected to remain constant at 30% over the life of the project. Spara requires a minimum after-tax return of 20% on projects of this type. Full capacity will be utilized.

Required:

a. Compute the relevant annual after-tax cash flows related to the CAD/CAM project.

b. Based on the computation in a. above, compute the following on an after-tax basis:
   1. Payback period for recovery of investment.
   2. Internal rate of return (use the appropriate table from page AP-178).
   3. Net present value (use the appropriate table from page AP-178).
   4. Excess present value index (profitability index).
### TABLE 1

**Compound Amount of $1.00 (The Future Value of $1.00)**

\[ S = P(1 + r)^t \]

<table>
<thead>
<tr>
<th>PERIODS</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>14%</th>
<th>16%</th>
<th>18%</th>
<th>20%</th>
<th>22%</th>
<th>24%</th>
<th>26%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.040</td>
<td>1.060</td>
<td>1.080</td>
<td>1.100</td>
<td>1.120</td>
<td>1.140</td>
<td>1.160</td>
<td>1.180</td>
<td>1.200</td>
<td>1.220</td>
<td>1.240</td>
<td>1.260</td>
</tr>
<tr>
<td>2</td>
<td>1.082</td>
<td>1.124</td>
<td>1.166</td>
<td>1.210</td>
<td>1.254</td>
<td>1.300</td>
<td>1.346</td>
<td>1.392</td>
<td>1.440</td>
<td>1.488</td>
<td>1.538</td>
<td>1.588</td>
</tr>
<tr>
<td>3</td>
<td>1.125</td>
<td>1.191</td>
<td>1.260</td>
<td>1.331</td>
<td>1.405</td>
<td>1.482</td>
<td>1.561</td>
<td>1.643</td>
<td>1.728</td>
<td>1.816</td>
<td>1.907</td>
<td>2.000</td>
</tr>
<tr>
<td>4</td>
<td>1.170</td>
<td>1.262</td>
<td>1.360</td>
<td>1.464</td>
<td>1.574</td>
<td>1.699</td>
<td>1.811</td>
<td>1.939</td>
<td>2.074</td>
<td>2.215</td>
<td>2.364</td>
<td>2.520</td>
</tr>
<tr>
<td>5</td>
<td>1.217</td>
<td>1.338</td>
<td>1.469</td>
<td>1.611</td>
<td>1.762</td>
<td>1.925</td>
<td>2.100</td>
<td>2.288</td>
<td>2.488</td>
<td>2.703</td>
<td>2.932</td>
<td>3.176</td>
</tr>
</tbody>
</table>

### TABLE 2

**Present Value of $1.00**

\[ P = \frac{S}{(1 + r)^t} \]

<table>
<thead>
<tr>
<th>PERIODS</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>14%</th>
<th>16%</th>
<th>18%</th>
<th>20%</th>
<th>22%</th>
<th>24%</th>
<th>26%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.962</td>
<td>0.943</td>
<td>0.926</td>
<td>0.909</td>
<td>0.893</td>
<td>0.877</td>
<td>0.862</td>
<td>0.847</td>
<td>0.833</td>
<td>0.820</td>
<td>0.806</td>
<td>0.794</td>
</tr>
<tr>
<td>2</td>
<td>0.925</td>
<td>0.890</td>
<td>0.857</td>
<td>0.826</td>
<td>0.797</td>
<td>0.768</td>
<td>0.743</td>
<td>0.718</td>
<td>0.694</td>
<td>0.672</td>
<td>0.650</td>
<td>0.630</td>
</tr>
<tr>
<td>3</td>
<td>0.889</td>
<td>0.840</td>
<td>0.794</td>
<td>0.751</td>
<td>0.712</td>
<td>0.675</td>
<td>0.641</td>
<td>0.609</td>
<td>0.579</td>
<td>0.551</td>
<td>0.524</td>
<td>0.500</td>
</tr>
<tr>
<td>4</td>
<td>0.855</td>
<td>0.792</td>
<td>0.735</td>
<td>0.683</td>
<td>0.636</td>
<td>0.592</td>
<td>0.552</td>
<td>0.516</td>
<td>0.482</td>
<td>0.451</td>
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<td>0.397</td>
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<tr>
<td>5</td>
<td>0.822</td>
<td>0.747</td>
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<td>0.621</td>
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<td>0.519</td>
<td>0.476</td>
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<td>0.341</td>
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<tr>
<td>6</td>
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<td>0.705</td>
<td>0.630</td>
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<td>0.507</td>
<td>0.456</td>
<td>0.410</td>
<td>0.370</td>
<td>0.335</td>
<td>0.303</td>
<td>0.275</td>
<td>0.250</td>
</tr>
</tbody>
</table>

### TABLE 3

**Compound Amount of Annuity of $1.00 in Arrears** (Future Value of Annuity)

\[ S_n = \frac{(1 + r)^n - 1}{r} \]

<table>
<thead>
<tr>
<th>PERIODS</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>14%</th>
<th>16%</th>
<th>18%</th>
<th>20%</th>
<th>22%</th>
<th>24%</th>
<th>26%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
<td>1.000</td>
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<tr>
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<td>2.040</td>
<td>2.060</td>
<td>2.080</td>
<td>2.100</td>
<td>2.120</td>
<td>2.140</td>
<td>2.160</td>
<td>2.180</td>
<td>2.200</td>
<td>2.220</td>
<td>2.240</td>
<td>2.260</td>
</tr>
</tbody>
</table>

### TABLE 4

**Present Value of Annuity of $1.00 in Arrears**

\[ P_n = \frac{1}{r} \left( \frac{1}{(1 + r)^n} \right) \]

<table>
<thead>
<tr>
<th>PERIODS</th>
<th>4%</th>
<th>6%</th>
<th>8%</th>
<th>10%</th>
<th>12%</th>
<th>14%</th>
<th>16%</th>
<th>18%</th>
<th>20%</th>
<th>22%</th>
<th>24%</th>
<th>26%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.962</td>
<td>0.943</td>
<td>0.926</td>
<td>0.909</td>
<td>0.893</td>
<td>0.877</td>
<td>0.862</td>
<td>0.847</td>
<td>0.833</td>
<td>0.820</td>
<td>0.806</td>
<td>0.794</td>
</tr>
<tr>
<td>2</td>
<td>1.866</td>
<td>1.833</td>
<td>1.783</td>
<td>1.736</td>
<td>1.690</td>
<td>1.647</td>
<td>1.605</td>
<td>1.566</td>
<td>1.528</td>
<td>1.492</td>
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</tr>
<tr>
<td>3</td>
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<td>2.673</td>
<td>2.577</td>
<td>2.487</td>
<td>2.402</td>
<td>2.322</td>
<td>2.246</td>
<td>2.174</td>
<td>2.106</td>
<td>2.042</td>
<td>1.981</td>
<td>1.923</td>
</tr>
<tr>
<td>4</td>
<td>3.630</td>
<td>3.465</td>
<td>3.312</td>
<td>3.170</td>
<td>3.037</td>
<td>2.914</td>
<td>2.798</td>
<td>2.690</td>
<td>2.589</td>
<td>2.494</td>
<td>2.404</td>
<td>2.320</td>
</tr>
</tbody>
</table>

*Payments (or receipts) at the end of each period.*

AP-178
Lond Co. produces joint products Jana and Reta, together with byproduct Bynd. Jana is sold at split-off, whereas Reta and Bynd undergo additional processing. Production data pertaining to these products for the year ended December 31, 1989 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Jana</th>
<th>Reta</th>
<th>Bynd</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>$120,000</td>
<td>$3,000</td>
<td>123,000</td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td>90,000</td>
<td>2,000</td>
<td>92,000</td>
<td></td>
</tr>
<tr>
<td>Separable costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable</td>
<td>$120,000</td>
<td>$3,000</td>
<td>123,000</td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td>90,000</td>
<td>2,000</td>
<td>92,000</td>
<td></td>
</tr>
<tr>
<td>Production in pounds</td>
<td>50,000</td>
<td>40,000</td>
<td>10,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Sales price per pound</td>
<td>$4.00</td>
<td>$7.50</td>
<td>$1.10</td>
<td></td>
</tr>
</tbody>
</table>

There were no beginning or ending inventories. No materials are spoiled in production. Variable costs change in direct proportion to production volume. Bynd's net realizable value is deducted from joint costs. Joint costs are allocated to joint products to achieve the same gross margin percentage for each joint product.

Required:

a. Prepare the following schedules for Lond Co. for the year ended December 31, 1989:
   1. Total gross margin.
   2. Allocation of joint costs to Jana and Reta.


c. Prepare the following schedules for Lond Co. for the year ending December 31, 1990:
   1. Projected production in pounds for each product at full capacity.
   2. Differential revenues (excluding Reta).
   3. Differential costs.
   4. Sales price required per pound of Reta in order for Lond to achieve the same gross margin as that for 1989.

Although 1989 performance could be repeated for 1990, Lond is considering possible operation of the plant at full capacity of 120,000 pounds. The relative proportions of each product's output with respect to cost behavior and production increases would be unchanged. Market surveys indicate that prices of Jana and Bynd would have to be reduced to $3.40 and $0.90, respectively. Reta's expected price decline cannot be determined.
Lane College is developing schedules for its overall budget projection for the 1990-91 academic year. Relevant 1989-90 data include:

<table>
<thead>
<tr>
<th></th>
<th>Undergraduates</th>
<th>Graduates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrollment</td>
<td>4,200</td>
<td>1,300</td>
</tr>
<tr>
<td>Average number of credit hours carried each year per student</td>
<td>30</td>
<td>24</td>
</tr>
<tr>
<td>Average number of students per class</td>
<td>25</td>
<td>14</td>
</tr>
<tr>
<td>Average faculty teaching load in credit hours per year (number of classes taught multiplied by 3 credit hours per class)</td>
<td>(8 × 3) 24</td>
<td>(6 × 3) 18</td>
</tr>
<tr>
<td>Average faculty salary and benefits</td>
<td>$50,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Tuition per credit hour (no other fees required)</td>
<td>$200</td>
<td>$300</td>
</tr>
</tbody>
</table>

Changes projected for 1990-91 and additional information:

1. Enrollments are expected to increase by 5 percent for both undergraduate and graduate programs.
2. Average faculty salary and benefits are expected to increase by 3 percent.
3. Lane has not previously used graduate students for teaching undergraduates, but will do so for 1990-91. All of the projected increased undergraduate enrollment will be taught by graduate students. Lane will recruit these graduate teaching assistants (TA’s) in addition to the 5 percent student increase indicated. Each TA will carry half an average graduate student load and half an average faculty teaching load. TA’s will receive a full remission of tuition fees and $10,000 in salary and benefits. For budgeting purposes, the tuition remission is considered both a tuition revenue and a tuition scholarship.
4. Non-faculty costs (excluding scholarships) for 1990-91 are to be budgeted by fixed and variable elements derived from estimates of cost at the following two levels of registration:

<table>
<thead>
<tr>
<th></th>
<th>Total student credit hours (both schools)</th>
<th>Total estimated non-faculty costs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>140,000</td>
<td>$21,960,000</td>
</tr>
<tr>
<td></td>
<td>180,000</td>
<td>$22,320,000</td>
</tr>
</tbody>
</table>

Required:

a. Prepare the following 1990-91 budget schedules for each program:
   1. Projected enrollment.
   2. Projected student credit hours.
   3. Projected number of full-time faculty and TA’s.
   4. Projected salaries and benefits for full-time faculty and TA’s.
   5. Projected tuition revenue.

b. 1. Calculate the fixed and variable elements in the non-faculty costs.
   2. Calculate the budgeted non-faculty costs, including scholarships, for the 1990-91 academic year.
Selected Questions

Number 5 (Estimated time — — 40 to 50 minutes)

The following information pertains to the pricing and delivery functions of Tapa Wholesale Company:

<table>
<thead>
<tr>
<th>Number of sales made to customers in 1988</th>
<th>20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average number of items per sale in 1988</td>
<td>4</td>
</tr>
<tr>
<td>Number of sales projected for 1989</td>
<td>24,000</td>
</tr>
<tr>
<td>Average number of items per sale projected for 1989</td>
<td>5</td>
</tr>
</tbody>
</table>

Sales invoices are priced by clerks whose wage rate is $6.00 per hour. Labor negotiations have resulted in a 10% increase in the hourly rate for 1989. It is expected that Tapa's pricing function will operate at the same level of productivity in 1989 as it did in 1988. Payroll tax rates and workers' compensation insurance rates will be the same in 1989 as in 1988. Prices for various items of supplies are expected to be the same in 1989 as in 1988.

The following costs were charged to Tapa's pricing function in 1988:

<table>
<thead>
<tr>
<th>Variable:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>$40,000</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>4,000</td>
</tr>
<tr>
<td>Workers' compensation insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,000</td>
</tr>
<tr>
<td>Total variable</td>
<td>47,000</td>
</tr>
<tr>
<td>Fixed</td>
<td>3,400</td>
</tr>
<tr>
<td>Total costs</td>
<td>$50,400</td>
</tr>
</tbody>
</table>

Fixed costs are allocated equally to all units. Except for delivery costs, all variable costs vary directly with the number of items priced. Supplies increase in proportion to the increase in the number of items priced. Tapa sells three products: Arcil, Balo, and Cacha. Differences in size and weight among these products affect variable delivery costs. For example, truck capacity is 10 units of Arcil, or 5 units of Balo, or 4 units of Cacha. Units projected to be delivered in 1989 are as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arcil</td>
<td>60,000</td>
</tr>
<tr>
<td>Balo</td>
<td>40,000</td>
</tr>
<tr>
<td>Cacha</td>
<td>20,000</td>
</tr>
<tr>
<td>Total</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Projected 1989 costs for the delivery function are as follows:

<table>
<thead>
<tr>
<th>Variable</th>
<th>$228,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Required:

a. Prepare the 1989 budget of all costs for Tapa's pricing function.

b. Prepare a schedule showing the 1989 standard delivery cost per unit of each of the three products sold by Tapa.

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:

(continued)
Accounting Practice

2N88
Number 5 (cont.)

<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>
</tr>
</thead>
<tbody>
<tr>
<td>Warehouse and delivery</td>
<td></td>
</tr>
<tr>
<td>Warehouse depreciation</td>
<td>$10,000</td>
</tr>
<tr>
<td>Warehouse operations</td>
<td>15,000</td>
</tr>
<tr>
<td>Delivery</td>
<td>35,000</td>
</tr>
<tr>
<td>Central office</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>30,000</td>
</tr>
<tr>
<td>Other</td>
<td>2,000</td>
</tr>
<tr>
<td>Total corporation overhead</td>
<td></td>
</tr>
<tr>
<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.

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.

AP-182
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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Gross margin</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Selling and administrative costs</td>
<td></td>
</tr>
<tr>
<td>Commissions</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>All other costs (fixed)</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>2,100,000</td>
</tr>
<tr>
<td>Income before income tax</td>
<td>1,900,000</td>
</tr>
<tr>
<td>Income tax (30%)</td>
<td>570,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,330,000</td>
</tr>
</tbody>
</table>

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.

**Selected Questions**

2M68

Number 5 (Estimated time — 40 to 50 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**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns in process, March 1</td>
<td>200</td>
</tr>
<tr>
<td>(25% complete)</td>
<td></td>
</tr>
<tr>
<td>Returns started in March</td>
<td>825</td>
</tr>
<tr>
<td>Returns in process, March 31</td>
<td>125</td>
</tr>
<tr>
<td>(80% complete)</td>
<td></td>
</tr>
</tbody>
</table>

**Actual cost data**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns in process, March 1</td>
<td>$6,000</td>
</tr>
<tr>
<td>Labor</td>
<td></td>
</tr>
<tr>
<td>Overhead</td>
<td>2,500</td>
</tr>
<tr>
<td>Labor, March 1 to 31</td>
<td>89,000</td>
</tr>
<tr>
<td>4,000 hours</td>
<td></td>
</tr>
<tr>
<td>Overhead, March 1 to 31</td>
<td>45,000</td>
</tr>
</tbody>
</table>

**Required:**

a. Using the weighted average method, compute the following for each cost element:

1) Equivalent units of performance.
2) Actual cost per equivalent unit.

b. Compute the actual cost of returns in process at March 31.

c. Compute the standard cost per return.

d. Prepare a schedule for internal reporting analyzing March performance, using the following variances, and indicating whether these variances are favorable or unfavorable:

1) Total labor.
2) Labor rate.
3) Labor efficiency.
4) Total overhead.
5) Overhead volume.
6) Overhead budget.

AP-183
Albury City was incorporated as a municipality and began operations on January 1, 1990. The budget approved by the City Council was recorded, but the cash basis was used in Albury’s books for all 1990 transactions. Albury has decided to use encumbrance accounting. Albury’s cash basis general fund trial balance at December 31, 1990, is presented below and in the tearout worksheet on page AP-186.

**Debits**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$477,800</td>
</tr>
<tr>
<td>Expenditures</td>
<td>145,000</td>
</tr>
<tr>
<td>Estimated revenues</td>
<td>228,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$851,000</strong></td>
</tr>
</tbody>
</table>

**Credits**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriations</td>
<td>$204,000</td>
</tr>
<tr>
<td>Revenues</td>
<td>216,800</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>400,000</td>
</tr>
<tr>
<td>Premium on bonds payable</td>
<td>6,000</td>
</tr>
<tr>
<td>Fund balance</td>
<td>24,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$851,000</strong></td>
</tr>
</tbody>
</table>

**Additional information:**

<table>
<thead>
<tr>
<th></th>
<th>Budgeted</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property taxes</td>
<td>205,200</td>
<td>$192,000</td>
</tr>
<tr>
<td>Licenses</td>
<td>14,800</td>
<td>15,800</td>
</tr>
<tr>
<td>Fines</td>
<td>8,200</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$228,200</strong></td>
<td><strong>$216,800</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Budgeted</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Appropriations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>$ 90,000</td>
<td>$ 77,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>38,000</td>
<td>22,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>76,000</td>
<td>46,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$204,000</strong></td>
<td><strong>$145,000</strong></td>
</tr>
</tbody>
</table>

It was estimated that 5% of the property taxes would not be collected. Accordingly, property taxes were levied to yield the budgeted amount of $205,200. Taxes of $192,000 had been collected by December 31, 1990, and it was expected that all remaining collectible taxes would be received by February 28, 1991.

Supplies of $8,000 and equipment of $20,000 were received, but the vouchers were unpaid at December 31, 1990. Purchase orders were still outstanding for supplies and equipment not yet received, in the amounts of $2,400 and $7,600, respectively.
Selected Questions

It was decided to record the $3,400 physical inventory of supplies on hand at December 31, 1990. In conformity with a city ordinance, expenditures are based on purchases rather than usage.

On November 1, 1990, Albury issued 4% general obligation term bonds of $400,000 at 101 1/2. Interest is payable each May 1 and November 1 until the maturity date of November 1, 2009. Cash from the bond premium is to be set aside and restricted for eventual retirement of bond principal. The bonds were issued to finance the construction of a firehouse, but no contracts had been executed by December 31, 1990.

Required:
Detach the tear-out worksheet on page AP-186, and complete this worksheet showing adjustments and distributions to the proper funds or account groups, before closing entries, in conformity with generally accepted accounting principles applicable to governmental entities. Formal adjusting entries are not required.

Turn in the tear-out worksheet in the proper sequence with other answer sheets.
<table>
<thead>
<tr>
<th>Debits:</th>
<th>Trial balance</th>
<th>Adjustments Debit</th>
<th>Adjustments Credit</th>
<th>General fund</th>
<th>Debt service fund</th>
<th>Capital projects fund</th>
<th>Account groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$477,800</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures</td>
<td>145,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated revenues</td>
<td>228,200</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$851,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Credits:                      |               |                   |                   |              |                  |                       |                   |
| Appropriations                | $204,000      |                   |                   |              |                  |                       |                   |
| Revenues and other financing sources | 216,800   |                   |                   |              |                  |                       |                   |
| Bonds payable                 | 400,000       |                   |                   |              |                  |                       |                   |
| Premium on bonds payable      | 6,000         |                   |                   |              |                  |                       |                   |
| Fund balance                  | 24,200        |                   |                   |              |                  |                       |                   |
| Totals                        | $851,000      |                   |                   |              |                  |                       |                   |

Albury City
WORKSHEET TO CORRECT TRIAL BALANCE
December 31, 1990

DETACH, COMPLETE, AND TURN IN THIS TEAR-OUT WORKSHEET IN THE PROPER SEQUENCE WITH OTHER ANSWER SHEETS.
Children's Agency, a voluntary health and welfare organization, conducts two programs: Medical Services Program and Community Information Services Program. It had the following transactions during the year ended June 30, 1989:

1. Received the following contributions:
   - Unrestricted pledges $800,000
   - Restricted cash 95,000
   - Building fund pledges 50,000
   - Endowment fund cash 1,000

2. Collected the following pledges:
   - Unrestricted 450,000
   - Building fund 20,000

3. Received the following unrestricted cash revenues:
   - From theatre party (net of direct costs) 12,000
   - Bequests 10,000
   - Membership dues 8,000
   - Interest and dividends 5,000

4. Program expenses incurred (processed through vouchers payable):
   - Medical services 60,000
   - Community information services 15,000

5. Services expenses incurred (processed through vouchers payable):
   - General administration 150,000
   - Fund raising 200,000

6. Fixed assets purchased with unrestricted cash 18,000

7. Depreciation of all buildings and equipment in the land, buildings, and equipment fund was allocated as follows:
   - Medical services program 4,000
   - Community information services program 3,000
   - General administration 6,000
   - Fund raising 2,000

8. Paid vouchers payable 330,000

Required: Detach the tear-out worksheet on page AP-188.

On the tear-out worksheet, record the journal entries (without explanations) for the preceding transactions. With credit amounts placed in parentheses, insert the amounts in the proper columns for each of the following funds:

- Current Fund — Unrestricted
- Current Fund — Restricted
- Land, Buildings, and Equipment Fund
- Endowment Fund

Number the journal entries to coincide with the transaction numbers indicated.
**Children's Agency**

**JOURNAL ENTRIES**

*For the Year Ended June 30, 1989*

<table>
<thead>
<tr>
<th>Account Title</th>
<th>Current Fund</th>
<th>Land, Buildings, and Equipment Fund</th>
<th>Endowment Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unrestricted Dr. (Cr.)</td>
<td>Restricted Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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:

  | Description                                               | Amount  
  |-----------------------------------------------------------|--------
  | Donor’s bequest of cash                                   | $300,000 |
  | Gains on sales of securities                              | 100,000 |
  | Interest and dividends earned in 1984, 1985, and 1986     | 120,000 |
  | Total                                                     | $520,000 |

  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:

  | Description                                               | Amount  
  |-----------------------------------------------------------|--------
  | Donation of land in 1970, at appraised value              | $40,000 |
  | Appreciation in fair value of land as determined          |        |
  | by independent appraiser in 1980                          | 60,000  |
  | Total                                                     | $100,000 |

- **Building** comprises the following:

  | Description                                               | Amount  
  |-----------------------------------------------------------|--------
  | Hospital building completed in January 1947, when operations were started (estimated useful life 50 years), at cost | $720,000 |
  | Installation of elevator in January 1967                  |        |
  | (estimated useful life 20 years), at cost                | 80,000  |
  | Total                                                     | $800,000 |

**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>60,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in U.S. Treasury bills</td>
<td>400,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in corporate bonds</td>
<td>500,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest receivable</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>50,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>800,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>170,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td>410,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>70,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Endowment fund balance</td>
<td>520,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other fund balances</td>
<td>1,100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Selected Questions

**Trial Balance December 31, 1986**

<table>
<thead>
<tr>
<th>Account</th>
<th>General (Unrestricted)</th>
<th>Endowment Fund</th>
<th>Plant Replacement and Expansion Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
<td>Credit</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Trial Balance December 31, 1986</th>
<th>Totals_________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td>2,120,000</td>
</tr>
<tr>
<td>Credit</td>
<td></td>
</tr>
</tbody>
</table>

| Totals                          | 2,120,000       |
Accounting Practice

IX. Federal Taxation — Individuals, Estates, and Trusts

2M90
Number 4 (Estimated time — — 45 to 55 minutes)

The following information pertains to Earl Mayne (age 59) for the calendar year 1989:

Marital status


Dependents who reside with Earl and are totally supported by Earl

Alex — Earl's stepson, age 5. Alex has no income of his own.
Mary — Joan's mother, age 90. Mary received social security benefits of $6,600 in 1989, which she deposited in her savings account and did not withdraw.

Cash received in 1989

Salary — employed as a computer analyst
Gross amount $60,000
Amounts withheld
Federal income tax $10,000
State income tax 2,000
FICA tax 3,605
Medical insurance premiums 1,000
Life insurance premiums 600 17,205
Net amount received $42,795

Salary — employed as a part-time teacher
Gross amount $3,000
Amounts withheld
Federal income tax $100
FICA tax 225 325
Net amount received 2,675

Sale of principal residence
Gross sales price (sold for 100% cash) $99,800
State transfer tax $998
Legal fee 1,400 2,398 97,402

Gross rents from 5% interest in rental realty 1,200
Dividends on life insurance policy 410
Dividends on stocks of unrelated taxable domestic corporations 875
Proceeds from settlement of nonbusiness bad debt 350
Proceeds of life insurance policy on death of Earl's aunt 5,000
Interest on U.S. treasury notes 800

AP-192
**Selected Questions**

**Cash disbursed in 1989**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household and miscellaneous personal expenses</td>
<td>$45,000</td>
</tr>
<tr>
<td>State sales taxes substantiated by receipts</td>
<td>1,910</td>
</tr>
<tr>
<td>Estimated 1989 federal income tax payments</td>
<td>4,000</td>
</tr>
<tr>
<td>Fee paid to CPA for tax return preparation</td>
<td>500</td>
</tr>
<tr>
<td>Professional education courses required to maintain job skills</td>
<td>900</td>
</tr>
<tr>
<td>Membership dues to Society of Computer Analysts</td>
<td>250</td>
</tr>
<tr>
<td>Contribution to a national political party</td>
<td>200</td>
</tr>
<tr>
<td>Realty taxes on principal residence prior to sale</td>
<td>1,500</td>
</tr>
<tr>
<td>Share of realty taxes on 5%-owned rental realty</td>
<td>700</td>
</tr>
<tr>
<td>Share of maintenance on 5%-owned rental realty</td>
<td>1,300</td>
</tr>
<tr>
<td>State inheritance tax on bequest of stamp collection from aunt's estate</td>
<td>190</td>
</tr>
<tr>
<td>Premiums on life insurance policy</td>
<td>1,100</td>
</tr>
<tr>
<td>Driver's license for three-year term</td>
<td>36</td>
</tr>
<tr>
<td>Contributions to qualified charitable organizations</td>
<td>2,250</td>
</tr>
</tbody>
</table>

**Additional information:**

- Earl's basis for his principal residence (purchased in 1960 and sold in 1989) was $14,000. This was the only home ever owned by Earl or Joan. Earl does not intend to buy another home. Earl made the required election in his 1989 return to avail himself of the maximum applicable exclusion in order to minimize his 1989 taxable income.
- The rental reality in which Earl owns a 5% interest was purchased in 1988. Earl does not render any services in connection with this investment.
- The accumulated net premiums paid on Earl's life insurance policy have not been exceeded by dividends received on the policy.
- The nonbusiness bad debt arose in connection with a $2,500 loan made by Earl to a friend. The $2,150 unpaid balance of the loan is uncollectible.
- Earl's 1988 federal return showed a tax overpayment of $70, which Earl elected to credit to his 1989 estimated tax.
- Earl's 1988 state return showed no balance of tax due or overpayment.
- Personal exemptions and dependency exemptions are $2,000 each for 1989.
- The standard deductions for 1989 are as follows:

<table>
<thead>
<tr>
<th></th>
<th><strong>Basic</strong></th>
<th><strong>Additional</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint</td>
<td>$5,200</td>
<td>$600</td>
</tr>
<tr>
<td>Head of household</td>
<td>4,550</td>
<td>750</td>
</tr>
<tr>
<td>Single</td>
<td>3,100</td>
<td>750</td>
</tr>
</tbody>
</table>

**Required:**

a. State which one of the following tax rate schedules or tax tables is applicable for Earl's 1989 return: joint, head of household, or single.

b. Prepare a detailed schedule computing Earl Mayne's 1989 taxable income. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1989 taxable income. Round to the nearest dollar.

c. Assume that Earl Mayne's 1989 federal income tax is $10,082 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.

AP-193
The following information pertains to Fred and Laura Shaw, a married couple filing a joint federal income tax return for the calendar year 1988:

**Fred, age 73 — cash received in 1988**

Salary — employed as an industrial engineer  
Gross amount $80,000  
Amounts withheld  
Federal income tax $17,000  
State income tax 4,000  
FICA taxes 3,380  
Medical insurance premiums 1,200  
Net amount received $54,420  
Social security benefits 12,000  
Dividends on life insurance policy  (accumulated net premiums not exceeded) 400

**Laura, age 61 — cash received in 1988**

Salary — from part-time employment  
Gross amount $15,000  
Amounts withheld  
Federal income tax $2,800  
State income tax 120  
FICA taxes 1,127  
Net amount received 10,953  
Unemployment compensation benefits 600

**Cash received jointly in 1988**

Proceeds from sale of stock  
(Bought in 1970 — basis $9,000) 2,500  
Dividends from taxable domestic corporations 527  
Interest on U.S. Government Savings Bonds 100  
Total cash received $81,500

**Cash disbursed in 1988**

Household and miscellaneous personal expenses $50,000  
State sales taxes substantiated by receipts 1,900  
Estimated 1988 federal income tax payments 2,000  
Fee paid to CPA for tax return preparation 250  
Unreimbursed business travel away from home overnight 900  
Continuing professional education courses required to maintain job skills 700  
Membership dues to Society of Industrial Engineers 150  
Contribution to a national political party 200  
Realty taxes on primary residence 3,000  
Realty taxes on summer cottage 800  
Mortgage interest on primary residence 2,300  
Mortgage principal on primary residence 500  
Mortgage interest on summer cottage  (no payments on principal) 1,800  
Total cash disbursed $64,500
Selected Questions

Additional information:

- The 1987 joint federal income tax return showed a tax overpayment of $43, which the Shaws elected to credit to their 1988 estimated tax.

- The 1987 joint state income tax return showed no balance of tax due or overpayment.

- In June 1988, Fred donated 500 shares of stock of a listed corporation to a recognized charitable organization. Fred’s basis for this stock, which was bought in 1975, was $1,100. Fair market value of this stock on the date of the donation was $1,400.

- In July 1988, the summer cottage, which was not insured, sustained fire damage. Information pertaining to this property is as follows:

<table>
<thead>
<tr>
<th>Basis</th>
<th>$40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value immediately before the fire</td>
<td>66,000</td>
</tr>
<tr>
<td>Fair market value immediately after the fire</td>
<td>50,000</td>
</tr>
</tbody>
</table>

- The Shaws supported their daughter, Doris, who had been disabled since infancy, and who lived in the Shaw household. Doris had no income. She died on January 2, 1988.

- Personal exemptions and dependency exemptions are $1,950 each for 1988.

- The basic standard deduction is $5,000 and the additional standard deduction is $600 for 1988.

Required:

a. Prepare a detailed schedule computing Fred and Laura Shaw’s joint taxable income for 1988. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1988 taxable income. Round to the nearest dollar.

b. Assume that Fred and Laura Shaw’s 1988 federal income tax on their 1988 joint taxable income is $16,946 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.
Accounting Practice

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>

**Other cash expected to be received in 1987:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bequest under husband's will</td>
<td>25,000</td>
</tr>
<tr>
<td>Life insurance proceeds on husband's death</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividends from taxable domestic corporations</td>
<td>500</td>
</tr>
<tr>
<td>Gross lottery winnings in January 1987</td>
<td>2,000</td>
</tr>
</tbody>
</table>

**Security transaction in 1987:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds from sale of 500 shares of stock</td>
<td>10,000</td>
</tr>
<tr>
<td>(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.)</td>
<td></td>
</tr>
</tbody>
</table>

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>Description</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>

AP-196
Selected Questions

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.

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

2N90
Number 4 (Estimated time — — 45 to 55 minutes)

Esa, Inc., a wholesaler, commenced operations on January 2, 1989. Esa is an accrual basis, calendar-year corporation that made a timely and proper election to be treated as an S corporation.

Esa’s income statement for the year ended December 31, 1989 is presented below and in the tear-out worksheet on page AP-198.

Sales $500,000
Cost of goods sold 300,000
Gross profit 200,000

Operating expenses
Compensation of officer $90,000
Uncollectible accounts 7,000
Taxes 25,000
Depreciation 14,000
Contributions 5,000
Employee benefit programs 19,000
Amortization of organization costs 300
Other 20,700

Operating income 19,000
Net rental revenue 18,000
Portfolio revenue
Interest 5,600
Dividends 3,000
Short-term capital gain 9,000

Total income $ 54,600

Additional information:
• The officer’s compensation of $90,000 was received in 1989 by Carl Loren, Esa’s president and sole stockholder.
• Esa used the “reserve” method in computing uncollectible accounts expense of $7,000. Actual customers’ accounts receivable written off in 1989 because of uncollectibility amounted to $1,900.

• Included in the $25,000 expense for taxes are $400 in parking fines incurred while Esa’s trucks were making deliveries to customers, and $2,200 in income taxes paid to a foreign country where Esa has a sales outlet.
• The depreciation of $14,000 was computed under the straight-line method for book purposes. For tax purposes, depreciation was also $14,000, including the full $10,000 expense deduction claimed by Esa under Section 179.
• The contributions of $5,000 were made to recognized charitable organizations.
• Included in the employee benefit programs of $19,000 are Loren’s medical expenses amounting to $6,000.
• Esa’s organization costs of $1,500 are being amortized over a period of 60 months.
• Included in the other operating expenses of $20,700 is insurance expense of $8,000 in connection with establishment of a reserve for self-insurance.
• The interest revenue of $5,600 was earned on U.S. government obligations.
• The dividends of $3,000 were received from unrelated taxable domestic corporations.
• The short-term capital gain of $9,000 was realized on the sale of an investment in an unrelated taxable domestic corporation.
• Esa’s only payment to Loren during 1989 was Loren’s salary of $90,000. No other distributions were made.

Required: Detach the tear-out worksheet on page AP-198.

a. Complete the tear-out worksheet to convert Esa’s book amounts to Esa’s tax return amounts and Loren’s Schedule K-1 amounts for the year ended December 31, 1989.

b. State the due date for the filing of Esa’s 1989 S Corporation Income Tax Return.

AP-197
### Esa, Inc.

**WORKSHEET TO CONVERT BOOK AMOUNTS TO TAX RETURN AMOUNTS**

*For the Year Ended December 31, 1989*

<table>
<thead>
<tr>
<th></th>
<th>Per books</th>
<th>Adjustments</th>
<th>S Corporation tax return</th>
<th>Schedule K-1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>500,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>300,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Deductions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation of officer</td>
<td>90,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>7,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>14,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee benefit programs</td>
<td>19,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of organization costs</td>
<td>300</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>20,700</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total deductions</strong></td>
<td>181,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>19,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net rental revenue</strong></td>
<td>18,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Portfolio revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>5,600</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>3,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>9,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td>54,600</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Selected Questions

2M99
Number 4 (Estimated time — 45 to 55 minutes)

The following adjusted accounts appeared in the records of Elm Corp., an accrual basis corporation, for the year ended December 31, 1988. Numbers in brackets refer to the items in Additional information.

Revenues and gains

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$5,500,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>10,000</td>
</tr>
<tr>
<td>Interest</td>
<td>4,000</td>
</tr>
<tr>
<td>Gain on sale of stock</td>
<td>6,000</td>
</tr>
<tr>
<td>Equity in earnings of Luz Partnership</td>
<td>50,000</td>
</tr>
<tr>
<td>Key-man life insurance proceeds</td>
<td>200,000</td>
</tr>
<tr>
<td>Tax refund</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,773,000</strong></td>
</tr>
</tbody>
</table>

Cost and expenses

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>3,900,000</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>571,000</td>
</tr>
<tr>
<td>Doubtful accounts</td>
<td>15,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest</td>
<td>20,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>175,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>90,000</td>
</tr>
<tr>
<td>Other</td>
<td>30,000</td>
</tr>
<tr>
<td>Federal income tax</td>
<td>193,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5,094,000</strong></td>
</tr>
</tbody>
</table>

Net income $679,000

Additional information:

[1] Trade accounts receivable at December 31, 1988 and at December 31, 1987 amounted to $300,000 and $180,000, respectively.

[2] Dividends were declared and paid in 1988 by an unrelated taxable domestic corporation whose securities are traded on a major stock exchange.


[4] Gain on sale of stock arose from the following purchase and sale of stock in an unrelated corporation listed on a major stock exchange:

- Bought in 1980: Cost $12,000
- Sold in 1988: Proceeds of sale 18,000

[5] Elm owns 50% of Luz Partnership. The other 50% is owned by an unrelated individual. Luz reported the following tax information to Elm:

- Elm’s share of:
  - Partnership ordinary income $63,000
  - Net long-term capital loss (13,000)

[6] Elm owned the key-man life insurance policy, paid the premiums, and was the direct beneficiary. The proceeds were collected on the death of Elm’s controller.


[8] Cost of goods sold relates to Elm’s net sales.

[9] Salaries and wages includes officers’ compensation of $125,000.

[10] Doubtful accounts expense represents an addition to Elm’s allowance for doubtful accounts based on an aging schedule whereby Elm “reserves” all accounts receivable over 120 days for book purposes. The balance in Elm’s allowance for doubtful accounts was $142,000 at December 31, 1988. Actual bad debts written off in 1988 amounted to $9,000. Elm’s allowance for doubtful accounts at December 31, 1986 (at the beginning of the first year of the tax law change) was $120,000.


[12] Interest expense resulted from borrowing for working capital purposes.

[13] Contributions were all paid in 1988 to State University, specifically designated for the purchase of computers.

[14] Elm has always used straight-line depreciation for both book and tax purposes.

[15] Other expenses include premiums of $12,000 on the key-man life insurance policy covering the controller.

[16] Federal income tax is the amount estimated and accrued before preparation of the return.

Required:

Prepare a schedule of taxable income as it should appear on Elm’s 1988 federal income tax return. Show all items required to be included in the return. Assume that the alternative minimum tax is less than the regular tax. Any possible optional treatment should be resolved in a manner that will minimize Elm’s 1988 taxable income.
PROBLEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M91
Answer 4 (10 points)

a.

Kern, Inc.
LONG-TERM RECEIVABLES SECTION
OF BALANCE SHEET
December 31, 1990

9% note receivable from sale of idle building, due in annual installments of $250,000 to May 1, 1992, less current installment
$250,000 [1]*
8% note receivable from officer, due December 31, 1992, collateralized by 5,000 shares of Kern, Inc., common stock with a fair value of $225,000
200,000
Noninterest-bearing note from sale of patent, net of 10% imputed interest, due April 1, 1992
88,795 [2]
Installment contract receivable, due in annual installments of $88,332 to July 1, 1994, less current installment
219,668 [3]
Total long-term receivables
$758,463

b.

Kern, Inc.
SELECTED BALANCE SHEET ACCOUNTS
December 31, 1990

Current portion of long-term receivables:

Note receivable from sale of idle building
$250,000 [1]
Installment contract receivable
60,332 [3]
Total
$310,332

Accrued interest receivable:

Note receivable from sale of idle building
$30,000 [4]
Installment contract receivable
14,000 [5]
Total
$44,000

*Numbers in brackets are keyed to explanations of amounts.
c. Kern, Inc.  
INTEREST REVENUE FROM LONG-TERM RECEIVABLES AND GAINS RECOGNIZED ON SALE OF ASSETS  
For the year ended December 31, 1990

Interest revenue:

Note receivable from sale of idle building $52,500 [6]
Note receivable from sale of patent 6,195 [2]
Note receivable from officer 16,000 [7]
Installment contract receivable from sale of land 14,000 [5]
Total interest revenue $88,695

Gains recognized on sale of assets:

Patent $44,600 [8]
Land 100,000 [9]
Total gains recognized $144,600

Explanation of Amounts:

[1] Long-term portion of 9% note receivable at 12/31/90
   Face amount, 5/1/89 $750,000
   Less installment received 5/1/90 250,000
   Balance, 12/31/90 500,000
   Less installment due 5/1/91 250,000
   Long-term portion, 12/31/90 $250,000

[2] Noninterest-bearing note, net of imputed interest at 12/31/90
   Face amount, 4/1/90 $100,000
   Less imputed interest [$100,000 - $82,600 ($100,000 x 0.826)] 17,400
   Balance, 4/1/90 82,600
   Add interest earned to 12/31/90 [$82,600 x 10% x 9/12] 6,195
   Balance, 12/31/90 $88,795

[3] Long-term portion of installment contract receivable at 12/31/90
   Contract selling price, 7/1/90 $400,000
   Less cash down payment 120,000
   Balance, 12/31/90 280,000
   Less installment due 7/1/91 [$88,332 - $28,000 ($280,000 x 10%)] 60,332
   Long-term portion, 12/31/90 $219,668
Unofficial Answers

[4] Accrued interest — note receivable, sale of idle building at 12/31/90
   Interest accrued from 5/1 to 12/31/90 [$500,000 × 9% × 8/12] $ 30,000

[5] Accrued interest — installment contract at 12/31/90
   Interest accrued from 7/1 to 12/31/90 [$280,000 × 10% × ½] $ 14,000

[6] Interest revenue — note receivable, sale of idle building, for 1990
   Interest earned from 1/1 to 5/1/90 [$750,000 × 9% × 4/12] $ 22,500
   Interest earned from 5/1 to 12/31/90 [$500,000 × 9% × 8/12] 30,000
   Interest revenue $ 52,500

[7] Interest revenue — note receivable, officer, for 1990
   Interest earned 1/1 to 12/31/90 [$200,000 × 8%] $ 16,000

[8] Gain recognized on sale of patent
   Stated selling price $100,000
   Less imputed interest 17,400 [2]
   Actual selling price 82,600
   Less cost of patent (net)
      Carrying value 1/1/90 $40,000
      Less amortization 1/1 to 4/1/90 [$8,000 × ¼] 2,000 38,000
   Gain recognized $ 44,600

[9] Gain recognized on sale of land
   Selling price $400,000
   Less cost 300,000
   Gain recognized $100,000

AP-203
Cord Corp.
ADJUSTING JOURNAL ENTRIES
December 31, 1990
(Explanations not required)

<table>
<thead>
<tr>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Marketable equity securities</td>
<td>$ 30,000</td>
<td>$ 30,000 [a]</td>
</tr>
<tr>
<td>Realized gain on sale of marketable equity securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Unrealized loss on marketable equity securities</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Allowance to reduce marketable equity securities to market value</td>
<td></td>
<td>13,000 [b]</td>
</tr>
<tr>
<td>(3) Cost of sales</td>
<td>66,000</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
<td>66,000</td>
</tr>
<tr>
<td>(4) Property and equipment</td>
<td>48,000</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td></td>
<td>14,400 [c]</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>33,600 [c]</td>
</tr>
<tr>
<td>(5) Depreciation</td>
<td>8,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td>8,000 [d]</td>
</tr>
<tr>
<td>(6) Estimated loss from lawsuit</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td></td>
<td>60,000</td>
</tr>
<tr>
<td>(7) Deferred pension cost</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Additional pension liability</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>(8) Deferred tax asset</td>
<td>21,900 [i]</td>
<td></td>
</tr>
<tr>
<td>Income tax payable</td>
<td>13,200 [ii]</td>
<td></td>
</tr>
<tr>
<td>Income tax expense</td>
<td></td>
<td>35,100 [iii]</td>
</tr>
</tbody>
</table>

AP-204
### Unofficial Answers

#### Supporting Computations for Number 8

<table>
<thead>
<tr>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted total income tax expense for 1990</td>
<td></td>
</tr>
<tr>
<td>Income before income tax, as reported</td>
<td>$640,000</td>
</tr>
<tr>
<td>Add adjustment increasing income</td>
<td></td>
</tr>
<tr>
<td>Realized gain on sale of securities</td>
<td>30,000 [1]</td>
</tr>
<tr>
<td>Deduct adjustments decreasing income</td>
<td>670,000</td>
</tr>
<tr>
<td>Increase cost of sales for inventory overstatement</td>
<td>$66,000</td>
</tr>
<tr>
<td>Depreciation on pollution control devices</td>
<td>8,000</td>
</tr>
<tr>
<td>Adjusted taxable income before income tax</td>
<td>596,000</td>
</tr>
<tr>
<td>Adjusted actual income tax expense ($596,000 × 30%)</td>
<td>178,800</td>
</tr>
<tr>
<td>Deferred income tax benefits — based on following temporary differences:</td>
<td></td>
</tr>
<tr>
<td>Lawsuit expected to be settled in 1992</td>
<td>$60,000 [6]</td>
</tr>
<tr>
<td>Unrealized loss on short-term marketable equity securities</td>
<td>13,000 [2]</td>
</tr>
<tr>
<td>Total future tax losses which can be carried back to 1990</td>
<td>$73,000</td>
</tr>
<tr>
<td>[i] Deferred tax benefit of loss carryback ($73,000 × 30%)</td>
<td>21,900</td>
</tr>
<tr>
<td>Adjusted income tax expense</td>
<td>$156,900</td>
</tr>
<tr>
<td>[ii] Income tax expense, as reported</td>
<td>192,000</td>
</tr>
<tr>
<td>Adjusted actual income tax expense</td>
<td>178,800</td>
</tr>
<tr>
<td></td>
<td>13,200</td>
</tr>
<tr>
<td>[iii] Income tax expense, as reported</td>
<td>192,000</td>
</tr>
<tr>
<td>Adjusted income tax expense</td>
<td>156,900</td>
</tr>
<tr>
<td></td>
<td>35,100</td>
</tr>
</tbody>
</table>

#### Explanations of Amounts

[a] Gain on sale of marketable equity securities

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Cost</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$130,000</td>
<td>100,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

[b] Allowance to reduce marketable equity securities to market value

<table>
<thead>
<tr>
<th>Marketable equity securities, at cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 2/2/90 as reported</td>
<td>$125,000</td>
</tr>
<tr>
<td>Adjustment for recording error</td>
<td>30,000</td>
</tr>
<tr>
<td>Adjusted balance, 12/31/90</td>
<td>155,000</td>
</tr>
<tr>
<td>Market valuation, 12/31/90</td>
<td>142,000</td>
</tr>
<tr>
<td>Allowance required, 12/31/90</td>
<td>$13,000</td>
</tr>
</tbody>
</table>

[c] Prior year adjustment for pollution control devices

| Cost of installation, 12/29/89 | $48,000 |
| Deduct income tax effect ($48,000 × 30%) | 14,400 |
| Credit adjustment to retained earnings, 1/1/90 | $33,600 |

[d] Depreciation for 1990 on pollution control devices

| Cost of the installation on 12/29/89 | $48,000 |
| Depreciation for 1990 ($48,000 ÷ 6 years) | $8,000 |
Zues Manufacturing Corp.
BALANCE SHEET
December 31, 1989

Assets

Current Assets
[1]*
Cash $109,000
Accounts receivable (net) 317,700
Inventories 560,000
Total current assets $986,700

[2] Long-term investment, at cost 51,300
Less allowance for excess of cost over market 4,300 47,000

Property, plant, and equipment, at cost
[4] Land 200,000
Building $1,750,000
Machinery and equipment 1,964,000
Total 3,914,000
Less accumulated depreciation 420,000 3,294,000
Total property, plant, and equipment 3,494,000

Intangible asset
Goodwill 37,000

Other assets
Cash restricted for building purposes 100,000
Officer’s note receivable 30,000
Land held for future building site 250,000 380,000
Total assets $4,944,700

Liabilities and Stockholders’ Equity

Current Liabilities
[5] Accounts payable $119,800
[6&7] Current installments of long-term debt 200,000
Lawsuit liability 80,000
Income taxes payable 21,200
Deferred tax liability 5,000
Total current liabilities $426,000

Long-term debt
[6] Mortgage payable 800,000
Note payable 400,000
Deferred tax liability 23,000 1,223,000

Stockholders’ equity
[9] Common stock, authorized 100,000 shares of
$50 par value; issued 40,000 shares;
outstanding 39,800 shares 2,000,000
[9] Additional paid-in capital 231,000
Total paid-in capital 2,231,000
Retained earnings 1,075,400 3,306,400

Total 3,306,400
Unofficial Answers

[3] Less: Cost of treasury stock $6,400
    Unrealized loss on long-term investment 4,300 10,700
Total stockholders' equity 3,295,700
Total liabilities and stockholders' equity $4,944,700

Explanations of Amounts

[1] Cash, per unaudited balance sheet $225,000
    Less: Unrecorded checks in payment of accounts payable (14,000)
    NSF check not recorded (2,000)
    Cash restricted for building purposes (reported in other assets) (100,000)
Corrected balance $109,000

    Add charge-back for NSF check (see [1]) 2,000
    Less officer's note receivable (reported in other assets) (30,000)
Corrected balance $317,700

[3] Investments, per unaudited balance sheet $ 57,700
    Less: Long-term investment (reported separately) (51,300)
    Treasury stock (reported in stockholders' equity) (6,400)
Corrected balance $ 0

[4] Land, per unaudited balance sheet $450,000
    Less land acquired for future building site (reported in other assets) (250,000)
Corrected balance $200,000

[5] Accounts payable, per unaudited balance sheet $133,800
    Less unrecorded payments (see [1]) (14,000)
Corrected balance $119,800

[6] Mortgage payable, per unaudited balance sheet $900,000
    Less current portion ($50,000 × 2) (100,000)
    Refinanced as long-term mortgage payable $800,000

[7] Note payable, per unaudited balance sheet $500,000
    Less current portion (100,000)
    Long-term note payable $400,000

[8] Income taxes payable, per unaudited balance sheet $61,200
    Less prepaid income taxes (40,000)
Corrected balance $21,200

[9] Common stock, per unaudited balance sheet $2,231,000
    Less additional paid-in capital in excess of par value (231,000)
Corrected balance $2,000,000
Computation of Cox's Goodwill Implicit in the Terms of the Common Stock Issuance

a. Cash paid by Rice for 1,000 shares $86,000

<table>
<thead>
<tr>
<th>Contribution by Cox</th>
<th></th>
</tr>
</thead>
<tbody>
<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><strong>Total assets</strong></td>
<td><strong>123,600</strong></td>
</tr>
</tbody>
</table>

| Current fair value of liabilities assumed | |
| Accounts payable | 30,500 |
| Note payable | 10,000 |
| Loan payable, delivery van | 3,500 |
| Interest payable | 600 |
| Payroll taxes withheld and accrued | 2,100 |
| **Total liabilities assumed** | **46,700** |

| Net contribution by Cox for 1,000 shares | **76,900** |

| Cox's goodwill | $9,100 |
**Cox Stationers, Inc.**

**BALANCE SHEET**

*January 1, 1987*

### Assets

**Current Assets:**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$23,500</td>
<td></td>
</tr>
<tr>
<td>Accounts</td>
<td>$20,200</td>
<td></td>
</tr>
<tr>
<td>Less allowance for doubtful accounts</td>
<td>$3,300</td>
<td></td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>45,000</td>
<td></td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>1,900</td>
<td></td>
</tr>
<tr>
<td>Total current assets</td>
<td>$169,600</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>9,100</td>
<td></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$218,700</td>
<td></td>
</tr>
</tbody>
</table>

### Liabilities and Stockholders’ Equity

**Current Liabilities**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable, bank</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>Loan payable, delivery van</td>
<td>3,500</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>30,500</td>
<td></td>
</tr>
<tr>
<td>Accrued interest</td>
<td>600</td>
<td>[3]</td>
</tr>
<tr>
<td>Payroll taxes withheld and accrued</td>
<td>2,100</td>
<td></td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>$46,700</td>
<td></td>
</tr>
</tbody>
</table>

**Stockholders’ Equity**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $50 par:</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>authorized 7,500 shares; issued and outstanding 2,000 shares</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>72,000</td>
<td>[4]</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>$172,000</td>
<td></td>
</tr>
</tbody>
</table>

**Total liabilities and stockholders’ equity**

<table>
<thead>
<tr>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>$218,700</td>
<td></td>
</tr>
</tbody>
</table>

### Explanations of Amounts:

**[1]** Cash

- Balance, 12/31/86: $16,500
- 1/1/87, sale of common stock to Rice: 86,000
- Balance, 1/1/87: $102,500

**[2]** Prepaid insurance

- Paid, 7/1/86: $3,800
- Prepaid, 12/31/86 (× ½): $1,900

**[3]** Accrued interest on note payable

- Annual interest ($10,000 × 12%): $1,200
- July 1 — December 31, 1986 (× ½): $600

**[4]** Additional paid-in capital

- Total assets: $218,700
- Deduct liabilities: 46,700
- Total stockholders’ equity: 172,000
- Deduct common stock (2,000 shares × $50): 100,000
- Additional paid-in capital: $72,000

AP-209
Accounting Practice

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," for all examination questions prior to May 1989. All subsequent examination questions and unofficial answers relating to accounting for income taxes are and will be based on SFAS No. 96.

1M89
Answer 4 (10 points)

Pitt Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$6,250,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>3,750,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>2,500,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>1,212,500</td>
</tr>
<tr>
<td>Operating income</td>
<td>1,287,500</td>
</tr>
<tr>
<td>Interest expense</td>
<td>122,500</td>
</tr>
<tr>
<td>Income before unusual or infrequent items and income tax</td>
<td>1,165,000</td>
</tr>
<tr>
<td>Unusual or infrequent items</td>
<td></td>
</tr>
<tr>
<td>Loss on disposition of plant assets</td>
<td>$(225,000)</td>
</tr>
<tr>
<td>Gain on sale of long-term investments</td>
<td>130,000</td>
</tr>
<tr>
<td>Income before income tax and extraordinary item</td>
<td>1,070,000</td>
</tr>
<tr>
<td>Income tax</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>342,000 [1]</td>
</tr>
<tr>
<td>Deferred</td>
<td>27,000 [2]</td>
</tr>
<tr>
<td>Total</td>
<td>369,000</td>
</tr>
<tr>
<td>Income before extraordinary item</td>
<td>701,000</td>
</tr>
<tr>
<td>Extraordinary item — loss from earthquake (net of applicable income tax benefit of $142,500)</td>
<td>332,500 [3]</td>
</tr>
<tr>
<td>Net income</td>
<td>$368,500</td>
</tr>
</tbody>
</table>

Earnings per share

Income before extraordinary item | $2.98 [4] |
Extraordinary loss                | (1.41) *   |
Net income                         | $1.57 [5]  |

*Optional
Pitt Corp.

RECONCILIATION OF NET INCOME TO TAXABLE INCOME PER TAX RETURN
For the Year Ended December 31, 1988

Net income
Add: Income tax on continuing operations $368,500
   Officers' life insurance expense 369,000
   70,000
   807,500

Deduct: Income tax benefit — extraordinary loss 142,500

Taxable income per tax return $665,000

Explanation of amounts

[1] Total income tax excluding extraordinary item for 1988
   Income before income tax and extraordinary item $1,070,000
   Officers' life insurance expense 70,000
   Income subject to tax 1,140,000
   Income tax rate × 30%
   Income tax excluding extraordinary item $ 342,000

   Excess of book basis over tax basis in depreciable assets
   (Expected to reverse equally over next 5 years) $90,000
   Deferred income tax liability, 12/31/88 ($90,000 × 30%) $27,000
   Less beginning balance, 1/1/88 -0-
   Net change in deferred tax liability for 1988 $27,000

[3] Extraordinary item — Loss from earthquake damage
   (net of income tax) for 1988
   Loss from earthquake damage $475,000
   Income tax benefit (30% × $475,000) 142,500
   Net of income tax effect $332,500

[4] Earnings per share of income before extraordinary item for 1988
   Income before extraordinary item $701,000
   Weighted average number of shares outstanding for 1988
   [200,000 + 20,000 + 15,000 (⅓ × 30,000)] 235,000
   Earnings per share ($701,000 ÷ 235,000) $2.98

   Net income $368,500
   Weighted average number of shares 235,000
   Earnings per share ($368,500 ÷ 235,000) $1.57
Arion 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>69,670</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) 15,990</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>
</tbody>
</table>

Earnings per share
From continuing operations $0.070
From discontinued operations 0.016
Total before extraordinary item 0.086
From extraordinary item 0.010
Net income $0.096
Unofficial Answers

COMPUTATION OF CURRENT AND DEFERRED INCOME TAXES

Income from continuing operations before income tax $86,500
Less permanent difference — proceeds of life insurance policy 10,000
Balance subject to tax 76,500
Income tax rate \times 22\%
Income tax on continuing operations $16,830

Current
Income per income tax return $99,000
Less intraperiod tax allocations
Discontinued operations
Income before income tax $33,000
Loss on disposal (12,500) $20,500
Extraordinary item
Gain on acquisition of bonds payable 13,000 33,500
Taxable income on continuing operations 65,500
Income tax rate \times 22\%
Income tax — current $14,410

Deferred
Depreciation per income tax return $46,000
Depreciation per financial statements 30,000
Excess of depreciation per income tax return over depreciation per financial statements 16,000
Rental revenue received in advance (5,000) 11,000
Net timing differences Income tax rate \times 22\%
Income tax — deferred 2,420
Income tax on continuing operations $16,830

COMPUTATION OF INCOME FROM DISCONTINUED OPERATIONS
For the Six Months Ended June 30, 1987
(Date of Discontinuance)

Sales $100,000
Cost of sales 45,000
Gross margin 55,000
Administrative expenses 15,000
Operating income 40,000
Interest expense 7,000
Income before income tax 33,000
Income tax (at 22%) 7,260
Net income $25,740
C. Statement of Cash Flows

Linden Consulting Associates
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 1989
Increase (Decrease) in Cash

Cash flows from operating activities:
Cash received from customers $2,586,000 [1]
Cash paid to suppliers and employees (1,830,000) [2]
Dividends received from affiliate 96,000
Net cash provided by operating activities $852,000

Cash flows from investing activities:
Purchased property and equipment (170,000)

Cash flows from financing activities:
Principal payment of mortgage payable (20,000)
Proceeds for admission of new partner 340,000
Drawings against partners' capital accounts (630,000)
Net cash used in financing activities (310,000)

Net increase in cash 372,000
Cash at beginning of year 280,000
Cash at end of year $652,000

Explanation of amounts:

[1] Fee revenue $2,664,000
Less ending accounts receivable balance (446,000)
Add beginning accounts receivable balance 368,000
$2,586,000

[2] Operating expenses $1,940,000
Less: Depreciation $60,000
Ending accounts payable balance 320,000 (380,000)
Add beginning accounts payable balance 270,000
$1,830,000
b.

Reconciliation of net income to net cash provided by operating activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$900,000</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities:</td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>$64,000</td>
</tr>
<tr>
<td>Undistributed earnings of affiliate</td>
<td>(84,000)  [1]</td>
</tr>
<tr>
<td>Change in assets and liabilities:</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(78,000)</td>
</tr>
<tr>
<td>Increase in accounts payable and accrued expenses</td>
<td>50,000</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>(48,000)</td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$852,000</td>
</tr>
</tbody>
</table>

[1] Linden's share of Zach, Inc.'s:

- Reported net income for 1989 (25% × $720,000) $180,000
- Cash dividends paid for 1989 (25% of $384,000) 96,000
- Undistributed earnings for 1989 $84,000

c.

Linden Consulting Associates
ANALYSIS OF CHANGES IN PARTNERS’ CAPITAL ACCOUNTS
For the Year Ended December 31, 1989

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Garr</th>
<th>Pat</th>
<th>Scott</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1988</td>
<td>$1,700,000</td>
<td>$1,020,000</td>
<td>$680,000</td>
<td>$—</td>
</tr>
<tr>
<td>Capital investment</td>
<td>340,000</td>
<td>—</td>
<td>—</td>
<td>340,000</td>
</tr>
<tr>
<td>Allocation of net income</td>
<td>900,000</td>
<td>450,000</td>
<td>270,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Balance before drawings</td>
<td>2,940,000</td>
<td>1,470,000</td>
<td>950,000</td>
<td>520,000</td>
</tr>
<tr>
<td>Drawings</td>
<td>630,000</td>
<td>280,000</td>
<td>200,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Balance, December 31, 1989</td>
<td>$2,310,000</td>
<td>$1,190,000</td>
<td>$750,000</td>
<td>$370,000</td>
</tr>
</tbody>
</table>
Kern, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 1988
Increase (Decrease) in Cash

Cash flows from operating activities:

Net income $305,000

Adjustments to reconcile net income to net cash provided by operating activities:

- Depreciation 82,000 [1]
- Amortization of patent 9,000
- Loss on sale of equipment 10,000
- Equity in income of Word Corp. (30,000) [2]
- Gain on sale of marketable equity securities (19,000)
- Decrease in allowance to reduce marketable equity securities to market (15,000)
- Increase in accounts receivable (35,000)
- Decrease in inventories 80,000
- Decrease in accounts payable and accrued liabilities (115,000)

Net cash provided by operating activities $272,000

Cash flows from investing activities:

- Sale of marketable equity securities $119,000
- Sale of equipment 18,000
- Purchase of equipment (120,000)

Net cash provided by investing activities 17,000

Cash flows from financing activities:

- Issuance of common stock $260,000 [3]
- Cash dividend paid (85,000)
- Payment on note payable (300,000)

Net cash used in financing activities (125,000)

Net increase in cash 164,000
Cash at beginning of year 307,000
Cash at end of year $471,000

Explanations of Amounts:

[1] Depreciation
Net increase in accumulated depreciation for year ended 12/31/88 $ 65,000
Accumulated depreciation on equipment sold 17,000
Depreciation for 1988 $ 82,000

Reported net income for 1988 $150,000
Kern’s ownership × 20%
Equity in income of Word Corp. for 1988 $ 30,000

[3] Issuance of common stock
4/15/88, issued 20,000 shares for cash at $13 per share $260,000
D. Statement of Owners' Equity

1M90
Answer 5 (10 points)

a.

Mart, Inc.
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1989

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, December 31, 1988 As originally reported</td>
<td>$3,250,000</td>
</tr>
<tr>
<td>Less prior period adjustment from error overstating inventories at December 31, 1988</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less income tax effect</td>
<td>60,000</td>
</tr>
<tr>
<td>As restated</td>
<td>3,110,000</td>
</tr>
<tr>
<td>Net income</td>
<td>2,250,000</td>
</tr>
<tr>
<td>Deduct cash dividends on:</td>
<td></td>
</tr>
<tr>
<td>Preferred stock</td>
<td>450,000 [1]</td>
</tr>
<tr>
<td>Common stock</td>
<td>2,480,000 [2]</td>
</tr>
<tr>
<td>Balance, December 31, 1989</td>
<td>$2,430,000</td>
</tr>
</tbody>
</table>

b.

Mart, Inc.
STOCKHOLDERS' EQUITY
December 31, 1989

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock, $50 par value, 9% cumulative, convertible; 250,000 shares authorized; 100,000 shares issued and outstanding</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Common stock, $5 par value; 6,000,000 authorized; 2,500,000 shares issued, of which 10,000 shares are held in treasury</td>
<td>12,500,000 [3]</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>2,430,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>31,380,000</td>
</tr>
<tr>
<td>Less contra accounts:</td>
<td></td>
</tr>
<tr>
<td>Common stock in treasury, 10,000 shares at cost</td>
<td>$160,000 [5]</td>
</tr>
<tr>
<td>Excess of cost over fair market value of a long-term investment in a marketable equity security</td>
<td>50,000 [6]</td>
</tr>
</tbody>
</table>

$31,170,000
**Mart, Inc.**

**COMPUTATION OF BOOK VALUE PER SHARE OF COMMON STOCK**

*December 31, 1989*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total stockholders’ equity</td>
<td>$31,170,000</td>
</tr>
<tr>
<td>Deduct allocation to preferred stock, at liquidation value [100,000 shares × $55]</td>
<td>5,500,000</td>
</tr>
<tr>
<td><strong>Allocation to common stock</strong></td>
<td><strong>$25,670,000</strong></td>
</tr>
<tr>
<td>[Shares outstanding 2,490,000 (2,500,000 – 10,000)]</td>
<td></td>
</tr>
<tr>
<td><strong>[$25,670,000 ÷ 2,490,000]</strong></td>
<td><strong>$10.31</strong></td>
</tr>
</tbody>
</table>

**Explanation of Amounts**

1. **Preferred stock dividend**
   - Par value of all outstanding preferred stock shares: $5,000,000
   - Dividend rate: 9%
   - Dividends paid on preferred stock: $450,000

2. **Common stock dividend**
   - Number of common stock shares outstanding, 12/31/88: 2,000,000
   - Number of common stock shares issued, 4/30/89: 500,000
   - Total common stock shares issued: 2,500,000
   - Less: Treasury stock shares acquired 2/1/89: 20,000
   - Shares outstanding, 7/1/89: 2,480,000
   - Dividends paid (2,480,000 × $1): $2,480,000

3. **Common stock shares issued (see [2] above)**
   - 2,500,000
   - Par value per share: $5
   - Common stock at par value ($5 × 2,500,000): $12,500,000

4. **Additional paid-in capital**
   - Balance, December 31, 1988: $7,500,000
   - From issuance of stock:
     - 100,000 shares of preferred stock on 1/5/89: $400,000
     - 500,000 shares of common stock on 4/30/89: $3,500,000
   - From sale of 10,000 shares of treasury stock on 11/6/89: $50,000
   - Balance, December 31, 1989: $11,450,000
### Unofficial Answers

<table>
<thead>
<tr>
<th>Shares</th>
<th>Amount of cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock in treasury</td>
<td></td>
</tr>
<tr>
<td>Stock reacquired, 2/1/89</td>
<td>20,000</td>
</tr>
<tr>
<td>Stock sold, 11/6/89</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>10,000</td>
</tr>
</tbody>
</table>

| Excess of cost of long-term marketable equity security | |
| Cost of marketable equity security | $200,000 |
| Fair market value of marketable equity security, 12/31/89 | |
| [$15 \times 10,000 shares] | 150,000 |
| Total | $50,000 |
### Consolidating Statement Worksheet

**Cain Corp. and Subsidiary**

**December 31, 1989**

#### Income Statement

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Dr. (Cr.)</th>
<th>Frey, Inc. Dr. (Cr.)</th>
<th>Adjustments &amp; Eliminations Dr.</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>(3,800,000)</td>
<td>(1,500,000)</td>
<td>[6] 180,000</td>
<td>(5,120,000)</td>
</tr>
<tr>
<td>Dividends from Frey</td>
<td>(40,000)</td>
<td></td>
<td>[3] 40,000</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of warehouse</td>
<td>(30,000)</td>
<td></td>
<td>[4] 30,000</td>
<td></td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>2,360,000</td>
<td>870,000</td>
<td>[6] 162,000</td>
<td>3,068,000</td>
</tr>
<tr>
<td>Operating expenses (including depreciation)</td>
<td>1,100,000</td>
<td>440,000</td>
<td>[2] 12,000 [5] 2,000</td>
<td>1,550,000</td>
</tr>
<tr>
<td>Net income</td>
<td>(410,000)</td>
<td>(190,000)</td>
<td>[a] 262,000 [a] 164,000</td>
<td>(502,000)</td>
</tr>
</tbody>
</table>

#### Retained Earnings Statement

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Dr. (Cr.)</th>
<th>Frey, Inc. Dr. (Cr.)</th>
<th>Adjustments &amp; Eliminations Dr.</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 1/1/89</td>
<td>(440,000)</td>
<td>(156,000)</td>
<td>[1] 156,000</td>
<td>(440,000)</td>
</tr>
<tr>
<td>Net income</td>
<td>(410,000)</td>
<td>(190,000)</td>
<td>[a] 262,000 [a] 164,000</td>
<td>(502,000)</td>
</tr>
<tr>
<td>Dividends paid</td>
<td></td>
<td>40,000</td>
<td>[3] 40,000</td>
<td></td>
</tr>
<tr>
<td>Balance, 12/31/89</td>
<td>(850,000)</td>
<td>(306,000)</td>
<td>[b] 418,000 [b] 204,000</td>
<td>(942,000)</td>
</tr>
</tbody>
</table>

#### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Dr. (Cr.)</th>
<th>Frey, Inc. Dr. (Cr.)</th>
<th>Adjustments &amp; Eliminations Dr.</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>570,000</td>
<td>150,000</td>
<td></td>
<td>720,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>860,000</td>
<td>350,000</td>
<td>[7] 86,000</td>
<td>1,124,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>1,060,000</td>
<td>410,000</td>
<td>[6] 18,000</td>
<td>1,452,000</td>
</tr>
<tr>
<td>Land, plant and equipment</td>
<td>1,320,000</td>
<td>680,000</td>
<td>[1] 54,000 [4] 30,000</td>
<td>2,024,000</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(370,000)</td>
<td>(210,000)</td>
<td>[5] 2,000 [2] 9,000</td>
<td>(587,000)</td>
</tr>
<tr>
<td>Investment in Frey (at cost)</td>
<td>750,000</td>
<td></td>
<td>[1] 750,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td>[1] 60,000 [2] 3,000</td>
<td>57,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>4,190,000</td>
<td>1,380,000</td>
<td></td>
<td>4,790,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Cain Corp. Dr. (Cr.)</th>
<th>Frey, Inc. Dr. (Cr.)</th>
<th>Adjustments &amp; Eliminations Dr.</th>
<th>Adjusted Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities &amp; Stockholders' Equity:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable &amp; accrued expenses</td>
<td>(1,340,000)</td>
<td>(594,000)</td>
<td>[7] 86,000</td>
<td>(1,848,000)</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>(1,700,000)</td>
<td>(400,000)</td>
<td>[1] 400,000</td>
<td>(1,700,000)</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>(300,000)</td>
<td>(80,000)</td>
<td>[1] 80,000</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(850,000)</td>
<td>(306,000)</td>
<td>[b] 418,000</td>
<td>(942,000)</td>
</tr>
<tr>
<td>Total Liabilities &amp; Stockholders' Equity</td>
<td>(4,190,000)</td>
<td>(1,380,000)</td>
<td>1,100,000</td>
<td>(4,790,000)</td>
</tr>
</tbody>
</table>
Explanations of Adjustments & Eliminations

[1] To eliminate the reciprocal elements in investment, goodwill, equity and property accounts. Cain’s investment is carried at cost at December 31, 1989.

[2] To record amortization of the fair value in excess of book value of Frey’s machinery at date of acquisition ($54,000 ÷ 6) and amortization of goodwill ($60,000 ÷ 20) for the year ended December 31, 1989.


[5] To eliminate the excess depreciation on the warehouse building sold by Cain to Frey [$\frac{1}{2} \times $4,000 ($86,000 - $66,000 \times \frac{1}{2})$].

[6] To eliminate intercompany sales from Cain to Frey and the intercompany profit in Cain’s ending inventory as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>On hand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$180,000</td>
<td>$36,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>90,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

[7] To eliminate Cain’s intercompany balance to Frey for the merchandise it purchased.
### 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>[5] 90,000</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>Liabilities and stockholders' equity:</th>
<th>Peel, Inc.</th>
<th>Stagg, Inc.</th>
<th>Adjustments &amp; Eliminations</th>
<th>Consolidated Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>$2,465,000</td>
<td>$1,145,000</td>
<td>[3] $8,000</td>
<td>$2,882,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>1,900,000</td>
<td>1,300,000</td>
<td>[2] 320,000</td>
<td>2,880,000</td>
</tr>
<tr>
<td>Common stock, $25 par 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>[5] 90,000</td>
<td>4,290,000</td>
</tr>
<tr>
<td></td>
<td>$13,795,000</td>
<td>$4,875,000</td>
<td></td>
<td>$3,598,000</td>
</tr>
</tbody>
</table>

|                                      | $3,598,000 |             |                             | $15,102,000          |

**AP-222**
**b. Peel, Inc. and Subsidiary**

**CONSOLIDATED STATEMENT OF RETAINED EARNINGS**

*For the Year Ended December 31, 1987*

Balance, December 31, 1986:
- **As originally reported:** $2,506,000
- **Adjustment for pooling of interests with Stagg, Inc.:** 820,000
- **As restated:** 3,326,000

Net income: 1,380,000 [6] 4,706,000

Deduct cash dividends paid:
- **By Stagg, Inc., prior to combination:** 160,000 [7]
- **By Peel, Inc., after the combination:** 256,000
- **Total:** 416,000

Balance, December 31, 1987: **$4,290,000**

---

**Explanations of Worksheet Entries & Other Amounts**

1. To eliminate the reciprocal elements in investment and equity accounts.
2. To eliminate Peel’s investment in Stagg’s bonds.
3. To eliminate Peel’s intercompany accrued interest receivable on its investment in Stagg’s bonds for the period 10/1 - 12/31/87. ($320,000 × 10% × \(\frac{1}{4}\) = $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 × \(\frac{1}{2}\) = $90,000)
6. **Consolidated net income for 1987**
   - **Peel, Inc.:** $890,000
   - **Stagg, Inc.:** 580,000
   - **Total:** $1,470,000
   - **Deduct intercompany profit in inventory:** 90,000 [5] $1,380,000
7. **Dividend paid 6/15/87**
   - **[40,000 shares × $4]** $160,000
**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><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] 900</td>
<td>90,000</td>
</tr>
<tr>
<td>Accounts &amp; other current receivables</td>
<td>410,000</td>
<td>120,000</td>
<td>[f] 900</td>
<td>335,000</td>
</tr>
<tr>
<td>Merchandise inventory</td>
<td>920,000</td>
<td>670,000</td>
<td>[i] 3,000</td>
<td>1,587,000</td>
</tr>
<tr>
<td>Plant and equipment (net)</td>
<td>1,000,000</td>
<td>400,000</td>
<td></td>
<td>1,400,000</td>
</tr>
<tr>
<td>Investment in Sy Corp.</td>
<td>1,200,000</td>
<td></td>
<td>[a] 90,900 [b] 900 [c] 480,000 [d] 810,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td>480,000</td>
<td>[d] 48,000</td>
<td>432,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
<td>1,205,000</td>
<td></td>
<td>3,844,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Liabilities and Stockholders' Equity</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable and other current liabilities</td>
<td>140,000</td>
</tr>
<tr>
<td>Common stock ($10 par)</td>
<td>500,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,965,000</td>
</tr>
<tr>
<td>Minority interest, 10%</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>3,605,000</td>
</tr>
</tbody>
</table>
Unofficial Answers

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
Accounting Practice

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

A. Cash, Marketable Securities, and Investments

1M89

Answer 5 (10 points)

a.

Poe Corp.

SCHEDULE OF CURRENT MARKETABLE EQUITY SECURITIES
December 31, 1988

<table>
<thead>
<tr>
<th>Number of shares</th>
<th>Cost</th>
<th>Market price per share</th>
<th>Market value</th>
<th>Unrealized gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Axe — preferred</td>
<td>500</td>
<td>$20,000</td>
<td>$56</td>
<td>$28,000</td>
</tr>
<tr>
<td>Axe — common</td>
<td>1,500</td>
<td>20,000</td>
<td>20</td>
<td>30,000</td>
</tr>
<tr>
<td>Purl — common</td>
<td>3,500</td>
<td>35,000</td>
<td>11</td>
<td>38,500</td>
</tr>
<tr>
<td>Day — common</td>
<td>1,700</td>
<td>42,500</td>
<td>22</td>
<td>37,400</td>
</tr>
</tbody>
</table>

$117,500 | $133,900 | $16,400 |

Valuation allowance [1] -0-
Carried at cost $117,500

b.

Poe Corp.

SCHEDULE OF NONCURRENT MARKETABLE EQUITY SECURITIES
December 31, 1988

Scott Corp. — 100,000 shares of common stock:

Cost: $1,700,000

Acquisition price
Increase in equity during 1988:
   Equity in Scott’s income $360,000
Less:
   Amortization of excess of cost over underlying equity $7,500 [2]
   Dividends received 200,000 207,500
Net increase in equity 152,500
Carrying amount of Poe Corp.'s investment in Scott $1,852,500

c.

Poe Corp.

SCHEDULE OF INVESTMENT INCOME
For the Year Ended December 31, 1988

Dividends:
   Axe Corp. — preferred (1,000 shares × $2.40 per share) $2,400
   Purl, Inc. — common (3,500 shares × $1.00 per share) 3,500
Total dividend revenue $5,900
Gains on marketable equity securities:

Unrealized gain on current marketable equity securities: 7,000 [1]

Realized gain/(loss) on sale of securities:

Purl, Inc. — common ($13 - $10 = $3 × 2,500 shares) $7,500

Day Co. — common ($55,000/2,000 shares × 110%), or cost per share of $25 - $21 selling price per share = $4 loss per share × 500 shares sold (2,000)

Net realized gain on sale of securities 5,500

Net gains on current marketable equity securities 12,500

Equity in income of Scott Corp.:

Poe’s 30% interest in Scott’s net income of $1,200,000 360,000

Amortization of excess of cost over underlying equity (7,500) [2]

Equity in income of Scott Corp. 352,500

$370,900

**Explanation of Amounts:**

[1] The valuation allowance of $7,000 at December 31, 1987, for current marketable equity securities should be eliminated by a debit to valuation allowance — current, and a credit to unrealized gain on current marketable equity securities. The $7,000 unrealized gain should be included in Poe’s income statement for the year ended December 31, 1988.

[2] Poe’s acquisition price for its 30% interest $1,700,000

Poe’s interest in the underlying equity 1,400,000

Excess of cost over underlying equity $300,000

Amortization based on 40 years $7,500

**B. Receivables and Accruals**

1M88

**Answer 5 (10 points)**

**Rowe Corp.**

**SCHEDULE OF CHANGES IN NOTE FROM SALE OF PATENT 1987**

Face amount, 5/1/87 (due 5/1/90) $500,000
Deduct imputed interest

[$500,000 - ($500,000 × 0.675)] 162,500
Balance, 5/1/87 337,500
Add interest earned to 12/31/87

($337,500 × 14% × 8/12) 31,500
Balance, 12/31/87, noncurrent $369,000

**AP-227**
Rowe Corp.
SCHEDULE OF CHANGES IN INSTALLMENT CONTRACT RECEIVABLE
1987

Balance, 12/31/86 $720,000
Deduct payment, 3/31/87 180,000
Balance, 3/31/87 and 12/31/87 540,000
Deduct installment due 3/31/88 180,000
Balance, 12/31/87, noncurrent $360,000

Rowe Corp.
SCHEDULE OF CHANGES IN INVESTMENT IN BLACK CORP., AT EQUITY 1987

<table>
<thead>
<tr>
<th>Underlying equity</th>
<th>Goodwill</th>
<th>Total at equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity in earnings</td>
<td>176,000</td>
<td>176,000</td>
</tr>
<tr>
<td>Dividend, 11/30/87</td>
<td>(150,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(3,500)</td>
<td>(3,500)</td>
</tr>
<tr>
<td>Balance, 12/31/87</td>
<td>$1,626,000</td>
<td>$276,500</td>
</tr>
</tbody>
</table>

Rowe Corp.
SCHEDULE OF CHANGES IN PATENT 1987

Cost, net of accumulated amortization, 12/31/86 $245,000
Deduct amortization, 1/1/87 to 5/1/87 ($315,000 ÷ 15 × 4/12) (7,000)
Cost of patent sold, 5/1/87 (238,000)
Balance, 12/31/87 $0

Rowe Corp.
SCHEDULE OF CHANGES IN TRADEMARK 1987

Cost, 1/2/87 $250,000
Deduct amortization for 1987 ($250,000 ÷ 40) 6,250
Balance, net of accumulated amortization, 12/31/87 $243,750
Unofficial Answers

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

Gain recognized on sale of patent $99,500 [5]

Interest revenue

Noninterest-bearing note $31,500 [Part a]

Installment contract 76,050 [6]

Total $107,550

Equity in earnings of Black Corp. $172,500 [7]

Amortization expense — intangibles

Patent $7,000 [Part a]

Trademark 6,250 [Part a]

Total $13,250

Explanations of Amounts

[5] Gain recognized on sale of patent

Selling price (net of imputed interest) $337,500 [Part a]

Carrying amount of patent at date of sale 238,000 [Part a]

Gain recognized $99,500

[6] Interest revenue — installment contract

Interest received 3/31/87 ($720,000 × 13%) $93,600

Interest 1/1/87 to 3/31/87 × ¼ $23,400

Interest accrued 4/1/87 to 12/31/87 ($540,000 × 13% × 9/12) 52,650

Interest, year ended 12/31/87 $76,050


Equity in Black's net income for 1987 $176,000 [2]

Deduct amortization of goodwill 3,500 [4]

Equity in earnings of Black Corp. $172,500

AP-229
D. Property, Plant, and Equipment Owned or Leased

1N89
Answer 4 (10 points)

a.

Schedule 1

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED
DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/87</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$275,000</td>
<td>—</td>
<td>—</td>
<td>$275,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>2,800,000</td>
<td>1,875,000</td>
<td>—</td>
<td>4,675,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,380,000</td>
<td>369,000</td>
<td>17,000</td>
<td>1,732,000</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>210,000</td>
<td>25,000</td>
<td>48,000</td>
<td>187,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>432,000</td>
<td>—</td>
<td>—</td>
<td>432,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,097,000</td>
<td>$2,269,000</td>
<td>$65,000</td>
<td>$7,301,000</td>
</tr>
</tbody>
</table>

Explanations of amounts:

[1] Construction cost of building
   Direct costs $1,095,000
   Overhead costs
      Fixed (15,000 hours × $25) $375,000
      Variable (15,000 hours × $27) 405,000
   $780,000

[2] Machinery and equipment purchased
   Invoice cost $325,000
   Installation cost (concrete embedding) 18,000
   Cost of gaining access to factory ($19,000 + $7,000) 26,000
   Total acquisition cost $369,000

b. 1.

Nan Co.
SCHEDULE OF DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1988

Buildings
   Carrying amount, 1/1/88 ($2,800,000 - $672,900) $2,127,100
   Building completed 1/6/88 1,875,000
   Total subject to depreciation 4,002,100
   150% declining balance [(100% ÷ 25) × 1.5] × 6%
   Depreciation for 1988 $240,126

Machinery and equipment
   Balance, 1/1/88 $1,380,000
   Straight-line (100% ÷ 10) × 10% $138,000
   Purchased 7/1/88 369,000
   Straight-line (10% × 6/12) × 5% 18,450
   Depreciation for 1988 $156,450

AP-230
Unofficial Answers

Automobiles and trucks
Carrying amount, 1/1/88 ($210,000 - $114,326)  $ 95,674
Deduct carrying amount, 1/1/88 on truck sold 9/30/88  30,000
Amount subject to depreciation  65,674
150% declining balance [(100% ÷ 5) × 1.5]  × 30%  $ 19,702
Automobile purchased 8/30/88  25,000
150% declining balance (30% × $1/12)  × 10%  2,500
Truck sold 9/30/88 — depreciation for 1988 (1/1 to 9/30/88) ($30,000 × 30% × $9/12)  6,750
Depreciation for 1988  $ 28,952

Leasehold improvements
Amortization for 1988 ($432,000 ÷ 12 years)  $36,000

b. 2.

Schedule 2

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th></th>
<th>Balance 12/31/87</th>
<th>Increase</th>
<th>Decrease</th>
<th>Balance 12/31/88</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>$ 672,900</td>
<td>$240,126</td>
<td>$ —</td>
<td>$ 913,026</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>367,500</td>
<td>156,450</td>
<td>14,025 [1]</td>
<td>509,925</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>114,326</td>
<td>28,952</td>
<td>24,750 [2]</td>
<td>118,528</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>108,000</td>
<td>36,000</td>
<td>—</td>
<td>144,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,262,726</td>
<td>$461,528</td>
<td>$38,775</td>
<td>$1,685,479</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>[1]</th>
<th>[2]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$17,000</td>
<td>$48,000</td>
</tr>
<tr>
<td>Carrying Amount</td>
<td>2,975</td>
<td>23,250*</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>$14,025</td>
<td>$48,750</td>
</tr>
</tbody>
</table>

*($30,000 - $6,750)

c.

Nan Co.
GAIN ON DISPOSITION OF PROPERTY, PLANT, AND EQUIPMENT
For the Year Ended December 31, 1988

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Carrying amount</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of truck</td>
<td>$23,500</td>
<td>$23,250</td>
</tr>
<tr>
<td>Machine exchanged for debt</td>
<td>4,000</td>
<td>2,975</td>
</tr>
<tr>
<td></td>
<td>$27,500</td>
<td>$26,225</td>
</tr>
</tbody>
</table>

AP-231
a. **Cord Company**

**ANALYSIS OF CHANGES IN PLANT ASSETS**

*For the Year Ended December 31, 1987*

<table>
<thead>
<tr>
<th></th>
<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>$312,500 [1]</td>
<td>$—</td>
<td>$487,500</td>
</tr>
<tr>
<td>Land improvements</td>
<td>—</td>
<td>192,000</td>
<td>—</td>
<td>192,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>1,500,000</td>
<td>937,500 [1]</td>
<td>—</td>
<td>2,437,500</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,125,000</td>
<td>385,000 [2]</td>
<td>17,000</td>
<td>1,493,000</td>
</tr>
<tr>
<td>Automobiles and trucks</td>
<td>172,000</td>
<td>12,500</td>
<td>24,000</td>
<td>160,500</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>216,000</td>
<td>—</td>
<td>—</td>
<td>216,000</td>
</tr>
<tr>
<td></td>
<td>$3,188,000</td>
<td>$1,839,500</td>
<td>$41,000</td>
<td>$4,986,500</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

$$\frac{1,250,000}{25\text{%}} = $48,000$$

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><strong>$750,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Amount</th>
<th>% to Total</th>
<th>Amount</th>
<th>% to Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>($1,250,000 × 25%)</td>
<td>$312,500</td>
<td></td>
</tr>
<tr>
<td>Building</td>
<td>($1,250,000 × 75%)</td>
<td>937,500</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,250,000</strong></td>
<td><strong>$1,250,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

[2] Machinery and equipment purchased 7/1/87

<table>
<thead>
<tr>
<th>Cost</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invoice cost</td>
<td>$325,000</td>
</tr>
<tr>
<td>Delivery cost</td>
<td>10,000</td>
</tr>
<tr>
<td>Installation cost</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total acquisition cost</strong></td>
<td><strong>$385,000</strong></td>
</tr>
</tbody>
</table>
**Unofficial Answers**

**Cord Company**

**DEPRECIATION AND AMORTIZATION EXPENSE**

*For the Year Ended December 31, 1987*

<table>
<thead>
<tr>
<th>Land improvements</th>
<th>Cost</th>
<th>$ 192,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Straight-line rate (100% + 12)</td>
<td>$ 192,000 × 8 1/3%</td>
</tr>
<tr>
<td></td>
<td>Annual depreciation</td>
<td>16,000</td>
</tr>
<tr>
<td></td>
<td>Depreciation on land improvements for 1987 (3/25 to 12/31/87)</td>
<td>$ 12,000</td>
</tr>
</tbody>
</table>

| 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] | $ 126,516 |
|           | Depreciation on buildings for 1987 | 126,516 |

<table>
<thead>
<tr>
<th>Machinery and equipment</th>
<th>Balance, 1/1/87</th>
<th>$1,125,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Straight-line rate (100% + 10)</td>
<td>$1,125,000 × 10%</td>
</tr>
<tr>
<td></td>
<td>Purchased 7/1/87</td>
<td>385,000</td>
</tr>
<tr>
<td></td>
<td>Depreciation for 1987 (10% × 6/12)</td>
<td>19,250</td>
</tr>
<tr>
<td></td>
<td>Depreciation on machinery and equipment for 1987</td>
<td>131,750</td>
</tr>
</tbody>
</table>

| 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] | $ 17,978 |
| Automobile purchased 8/30/87 | 12,500 |
| Depreciation for 1987 (30% × 4/12) | 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 |
| Amortization in leasehold improvements for 1987 | 21,600 |

**Total depreciation and amortization expense for 1987** | **$313,744** |
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>$438,000 [1]</td>
<td>$—</td>
<td>$788,000</td>
</tr>
<tr>
<td>Land improvements</td>
<td>180,000</td>
<td>—</td>
<td>—</td>
<td>180,000</td>
</tr>
<tr>
<td>Building</td>
<td>1,500,000</td>
<td>—</td>
<td>—</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>1,158,000</td>
<td>287,000 [2]</td>
<td>58,000</td>
<td>1,387,000</td>
</tr>
<tr>
<td>Automobiles</td>
<td>150,000</td>
<td>19,000 [3]</td>
<td>18,000</td>
<td>151,000</td>
</tr>
<tr>
<td>Total</td>
<td>$3,338,000</td>
<td>$744,000</td>
<td>$76,000</td>
<td>$4,006,000</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
   - Total $438,000

[2] Cost of machinery and equipment purchased 1/2/86
   - Invoice cost $260,000
   - Installation cost $27,000
   - Total $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
   - Total $19,000

AP-234
b. Pell Corporation
DEPRECIATION EXPENSE
For the Year Ended December 31, 1986

Land improvements
Cost $180,000
Straight-line rate \([100\% ÷ 15]\) \(\times 6\frac{2}{3}\%\)
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 \([(100\% ÷ 20) \times 1\frac{1}{2}]\) \(\times 7\frac{1}{2}\%\)
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 \(\times 10\%\) 110,000
Purchased 1/2/86 287,000
Depreciation \(\times 10\%\) 28,700
Machine sold 3/31/86 58,000
Depreciation from 1/1 to 3/31/86 \((10\% \times \frac{1}{4})\) \(\times 2.5\%\) 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 \([100\% ÷ 3 \times 1\frac{1}{2}]\) \(\times 50\%\)
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

<table>
<thead>
<tr>
<th>Gain or (loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of machine 3/31/86</td>
</tr>
<tr>
<td>Selling price $36,500</td>
</tr>
<tr>
<td>Carrying amount of machine sold ([$58,000 - $24,650 (Depreciation 4\frac{1}{4} \text{ years} \times 10%)]) 33,350</td>
</tr>
<tr>
<td>Gain on sale 3,150</td>
</tr>
<tr>
<td>Trade-in of automobile 12/31/86</td>
</tr>
<tr>
<td>Carrying amount of trade-in $4,500 [3]</td>
</tr>
<tr>
<td>Trade-in allowed (($19,000 - $15,250)) 3,750</td>
</tr>
<tr>
<td>Loss on trade-in $ (750)</td>
</tr>
<tr>
<td>Gain from asset disposals $2,400</td>
</tr>
</tbody>
</table>

AP-235
Accounting Practice

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

2N88
Answer 4 (10 points)

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable to bank</td>
<td>$ 75,000 [5]</td>
</tr>
<tr>
<td>Liability under capital lease</td>
<td>44,800 [2]</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>56,250 [3]</td>
</tr>
<tr>
<td>Total</td>
<td>$ 176,050</td>
</tr>
</tbody>
</table>

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
Unofficial Answers

<table>
<thead>
<tr>
<th></th>
<th>Liability under capital lease</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Liability under capital lease, 12/31/86</td>
<td></td>
<td>$280,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less principal portion of 12/31/87 payment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lease payment</td>
<td>$100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less imputed interest ($280,000 × 16%)</td>
<td>44,800</td>
<td>55,200</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Balance, 12/31/87</td>
<td></td>
<td>224,800</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less current principal payment due 12/31/88</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lease payment</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less imputed interest ($224,800 × 16%)</td>
<td>35,968</td>
<td>64,032</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Long-term portion, 12/31/87</td>
<td></td>
<td>$160,768</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Bonds payable</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bonds payable issued 7/1/87</td>
<td></td>
<td>$750,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Add amortization of bond discount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Effective interest ($750,000 × 15% × 6/12)</td>
<td>56,250</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less accrued interest payable 12/31/87</td>
<td></td>
<td>50,000</td>
<td>6,250</td>
</tr>
<tr>
<td></td>
<td>($1,000,000 × 10% × 6/12)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Balance, 12/31/87</td>
<td></td>
<td>$756,250</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Deferred income taxes</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deferred income taxes, 12/31/86</td>
<td></td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Add timing difference — excess of tax depreciation over book depreciation of $50,000 × 30%</td>
<td></td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Balance, 12/31/87</td>
<td></td>
<td>$115,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Interest expense on note payable to bank</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1/1/87 to 9/30/87 ($800,000 × 10% × 9/12)</td>
<td></td>
<td>$60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10/1/87 to 12/31/87 ($600,000 × 10% × 3/12)</td>
<td></td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest, year ended 12/31/87</td>
<td></td>
<td>$75,000</td>
<td></td>
</tr>
</tbody>
</table>

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)

Total stockholders' equity

$15,500,000

c. Fay, Inc.

INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank

$60,000 [8]

Debenture bonds payable

535,240 [9]

Total interest expense

$595,240

Explanations of Amounts

[1] 9% note payable to bank
Note payable, 11/1/87
Deduct installment due 11/1/88
Long-term portion, 12/31/87

$4,000,000
800,000
3,200,000

[2] Debenture bonds payable
Carrying amount, 12/31/86
Deduct amortization of bond premium
Interest paid 12/31/87 ($5,000,000 x 11%)
Less effective interest
($5,352,400 x 10%)
Carrying amount, 12/31/87

$5,352,400
550,000
535,240
14,760
$5,337,640

AP-238
### [3] Common stock issued

<table>
<thead>
<tr>
<th>Date</th>
<th>Shares</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/86</td>
<td>800,000</td>
<td>$8,000,000</td>
</tr>
<tr>
<td>3/2/87</td>
<td>40,000</td>
<td>400,000</td>
</tr>
<tr>
<td>12/31/87</td>
<td>840,000</td>
<td>$8,400,000</td>
</tr>
</tbody>
</table>

### [4] Additional paid-in capital

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 12/31/86</td>
<td>$2,295,000</td>
</tr>
<tr>
<td>Treasury stock reissued, 1/15/87</td>
<td>30,000</td>
</tr>
<tr>
<td>[$225,000 - $195,000 ($325,000 x 60%)]</td>
<td></td>
</tr>
<tr>
<td>Stock dividend issued, 3/2/87</td>
<td>160,000</td>
</tr>
<tr>
<td>[($14 - $10) x 40,000 shares]</td>
<td></td>
</tr>
<tr>
<td>Balance, 12/31/87</td>
<td>$2,485,000</td>
</tr>
</tbody>
</table>

### [5] Retained earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 12/31/86</td>
<td>$2,465,000</td>
</tr>
<tr>
<td>Stock dividend issued, 3/2/87</td>
<td>(560,000)</td>
</tr>
<tr>
<td>($14 x 40,000 shares)</td>
<td></td>
</tr>
<tr>
<td>Net income for 1987</td>
<td>2,860,000</td>
</tr>
<tr>
<td>Balance, 12/31/87</td>
<td>$4,765,000</td>
</tr>
</tbody>
</table>

### [6] Net unrealized loss on noncurrent marketable equity securities

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, 12/31/87</td>
<td>$20,000</td>
</tr>
<tr>
<td>[($20 - $18) x 10,000 shares]</td>
<td></td>
</tr>
</tbody>
</table>

### [7] Treasury stock at cost

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(10,000 ÷ 25,000 x $325,000)</td>
<td>$130,000</td>
</tr>
</tbody>
</table>

### [8] Interest expense on note payable to bank

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/1/87 to 12/31/87 ($4,000,000 x 9% x (\frac{1}{12}))</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

### [9] Interest expense on debenture bonds payable

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest paid 12/31/87 for year ended 12/31/87</td>
<td>$550,000</td>
</tr>
<tr>
<td>Deduct amortization of bond premium for year</td>
<td>14,760</td>
</tr>
<tr>
<td>Interest expense year ended 12/31/87</td>
<td>$535,240</td>
</tr>
</tbody>
</table>
Answer 5 (10 points)

**Spars Corp.**

**RELEVANT ANNUAL AFTER-TAX CASH FLOWS**

**CAD/CAM PROJECT**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings on elimination of current manual system (20,000 hrs. @ $20)</td>
<td>$400,000</td>
</tr>
<tr>
<td>Operating costs of CAD/CAM system</td>
<td>$200,000</td>
</tr>
<tr>
<td>Depreciation of CAD/CAM system ($480,000/6)</td>
<td>$80,000</td>
</tr>
<tr>
<td>Pre-tax savings</td>
<td>$120,000</td>
</tr>
<tr>
<td>Less income taxes ($120,000 × 30%)</td>
<td>$36,000</td>
</tr>
<tr>
<td>Increase in reported income</td>
<td>$84,000</td>
</tr>
<tr>
<td>Add depreciation</td>
<td>$80,000</td>
</tr>
<tr>
<td>Increase in annual net cash flows</td>
<td>$164,000</td>
</tr>
</tbody>
</table>

**b. 1. PAYBACK PERIOD**

Cost, $480,000/Increase in annual net cash flows, $164,000  

2.93 years

**b. 2. INTERNAL RATE OF RETURN**

<table>
<thead>
<tr>
<th>Rate</th>
<th>Annual cash flows</th>
<th>Factor</th>
<th>Present value</th>
<th>Investment</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>24%</td>
<td>$164,000</td>
<td>3.020</td>
<td>$495,280</td>
<td>$480,000</td>
<td>$15,280</td>
</tr>
<tr>
<td>26%</td>
<td>164,000</td>
<td>2.885</td>
<td>473,140</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2%</td>
<td></td>
<td></td>
<td></td>
<td>$22,140</td>
<td></td>
</tr>
</tbody>
</table>

Interpolation:

\[
\frac{15,280}{22,140} \times .02 = .0138
\]

Internal rate of return (.24 + .0138) = 25.38%

**b. 3. NET PRESENT VALUE**

Present value of annual net cash flows ($164,000 × 3.326)  

$545,464

Less investment  

480,000

Net present value  

$65,464

**b. 4. EXCESS PRESENT VALUE INDEX**

Present value of annual net cash flows  

$545,464

Investment  

$480,000

114%
**Unofficial Answers**

2N90

**Answer 5 (10 points)**

**Lond Co.**

**TOTAL GROSS MARGIN**

*For the Year Ended December 31, 1989*

<table>
<thead>
<tr>
<th></th>
<th>Jana</th>
<th>Reta</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
<td>$300,000</td>
<td>$500,000</td>
</tr>
</tbody>
</table>
| Cost of sales
  Joint costs ($236,000 − $6,000) | 230,000 | 230,000 |
  Separable costs | 210,000 | 210,000 |
| Total costs | 440,000 |         |         |
| Total gross margin (12%) | $ 60,000 |         |         |

**Lond Co.**

**ALLOCATION OF JOINT COSTS**

*For the Year Ended December 31, 1989*

<table>
<thead>
<tr>
<th></th>
<th>Jana</th>
<th>Reta</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
<td>$300,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less gross margin (12%)</td>
<td>24,000</td>
<td>36,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Less separable costs</td>
<td>210,000</td>
<td>210,000</td>
<td></td>
</tr>
<tr>
<td>Total deductions</td>
<td>246,000</td>
<td>270,000</td>
<td></td>
</tr>
<tr>
<td>Joint costs</td>
<td>$176,000</td>
<td>$ 54,000</td>
<td>$230,000</td>
</tr>
</tbody>
</table>

**Lond Co.**

**PRODUCT GROSS MARGINS**

*For the Year Ended December 31, 1989*

<table>
<thead>
<tr>
<th></th>
<th>Jana</th>
<th>Reta</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
<td>$300,000</td>
<td>$500,000</td>
</tr>
</tbody>
</table>
| Cost of sales
  Joint costs | 176,000 | 54,000 | 230,000 |
  Separable costs | 210,000 | 210,000 |         |
| Total costs | 176,000 | 264,000 |         |
| Gross margins | $ 24,000 | $ 36,000 | $ 60,000 |
b. *Lond Co.*

**COMPUTATION OF BREAKEVEN POINT IN POUNDS**

*For the Year Ended December 31, 1989*

<table>
<thead>
<tr>
<th>Sales</th>
<th>Jana</th>
<th>Reta</th>
<th>Bynd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
<td>300,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>$88,000</td>
<td>120,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Joint</td>
<td>3,000</td>
<td>211,000</td>
<td></td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$300,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution margin per pound</td>
<td>$3.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$148,000</td>
<td>90,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Total fixed costs</td>
<td>$240,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Breakeven point in pounds</td>
<td>$240,000 = 80,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

c. 1.

**Lond Co.**

**PROJECTED PRODUCTION IN POUNDS AT FULL CAPACITY**

*For the Year Ending December 31, 1990*

<table>
<thead>
<tr>
<th>Pounds of production for the year ended December 31, 1989</th>
<th>Jana</th>
<th>Reta</th>
<th>Bynd</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>50,000</td>
<td>40,000</td>
<td>10,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Projected increases</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jana .5 x 20,000</td>
<td>10,000</td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Reta .4 x 20,000</td>
<td></td>
<td>8,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bynd .1 x 20,000</td>
<td></td>
<td></td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Total increase</td>
<td></td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Projected pounds of production at full capacity</td>
<td>60,000</td>
<td>48,000</td>
<td>12,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

AP-242
Increase in sales of Jana at full capacity
Projected sales for 1990 (60,000 pounds @ $3.40) $204,000
Sales of Jana for 1989 (50,000 pounds @ $4.00) 200,000 $4,000

Decrease in sales of Bynd at full capacity
Projected sales for 1990 (12,000 pounds @ $0.90) $ 10,800
Sales of Bynd for 1989 (10,000 pounds @ $1.10) 11,000 200

Net increase in sales (excluding Reta) $3,800

Joint [(120,000 - 100,000) × ($88,000/100,000)] $17,600
Reta [(48,000 - 40,000) × ($120,000/40,000)] 24,000
Bynd [(12,000 - 10,000) × ($3,000/10,000)] 600
Increase in differential costs $42,200

Sales of Reta for 1989 $300,000
Projected 1990 net increase in differential costs 38,400
Recovery required from Reta $338,400
Sales price required per pound of Reta $338,400/48,000 = $7.05

PROOF
(Not Required)

<table>
<thead>
<tr>
<th></th>
<th>Jana</th>
<th>Reta</th>
<th>Joint</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected 1990 sales</td>
<td>$204,000</td>
<td>$338,400</td>
<td></td>
<td>$542,400</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>90,000</td>
<td></td>
<td>$148,000</td>
<td>238,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(20% higher than in 1989)</td>
<td>144,000</td>
<td></td>
<td>105,600</td>
<td>249,600</td>
</tr>
<tr>
<td>Less Bynd's net realizable value</td>
<td></td>
<td></td>
<td>(5,200)</td>
<td></td>
</tr>
<tr>
<td>($10,800 - 2,000 - 3,600)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total costs</td>
<td></td>
<td>482,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross margin (1990 and 1989)</td>
<td></td>
<td></td>
<td></td>
<td>$ 60,000</td>
</tr>
</tbody>
</table>
Accounting Practice

2M90
Answer 5 (10 points)

Lane College
PROJECTED ENROLLMENT
For the Academic Year 1990–91

<table>
<thead>
<tr>
<th></th>
<th>Undergraduate</th>
<th>Graduate</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrollment for 1989–90</td>
<td>4,200</td>
<td>1,300</td>
<td>5,500</td>
</tr>
<tr>
<td>Projected increase for 1990–91 — 5%</td>
<td>210</td>
<td>65</td>
<td>275</td>
</tr>
<tr>
<td>TA enrollment for 1990–91</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average number of undergraduate students per class</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average faculty teaching load in credit hours × 24</td>
<td>Product 600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>One-half</td>
<td>300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Projected increase in undergraduate enrollment for 1990–91</td>
<td>210</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average number of credit hours carried by each undergraduate student × 30</td>
<td>Product 6,300</td>
<td>21</td>
<td>21</td>
</tr>
<tr>
<td>Total expected enrollment</td>
<td>4,410</td>
<td>1,386</td>
<td>5,796</td>
</tr>
</tbody>
</table>

Lane College
PROJECTED STUDENT CREDIT HOURS
For the Academic Year 1990–91

<table>
<thead>
<tr>
<th></th>
<th>Undergraduate</th>
<th>Graduate</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected enrollment, excluding TA’s</td>
<td>4,410</td>
<td>1,365</td>
<td>5,775</td>
</tr>
<tr>
<td>Average number of credit hours carried by each student × 30</td>
<td></td>
<td>× 24</td>
<td></td>
</tr>
<tr>
<td>Credit hours, excluding TA’s</td>
<td>132,300</td>
<td>32,760</td>
<td>165,060</td>
</tr>
<tr>
<td>TA credit hours [21 × (1/2 of 24)]</td>
<td>252</td>
<td></td>
<td>252</td>
</tr>
<tr>
<td>Total student credit hours</td>
<td>132,300</td>
<td>33,012</td>
<td>165,312</td>
</tr>
</tbody>
</table>
**Unofficial Answers**

**Lane College**

**PROJECTED NUMBER OF FULL-TIME FACULTY AND TA'S**

*For the Academic Year 1990–91*

<table>
<thead>
<tr>
<th></th>
<th>Full-time</th>
<th>TA's</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>For undergraduate program</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enrollment for 1989–90</td>
<td>4,200</td>
<td></td>
</tr>
<tr>
<td>Average number of credit hours carried by each student</td>
<td>$\times 30$</td>
<td></td>
</tr>
<tr>
<td>Total undergraduate credit hours</td>
<td>126,000</td>
<td></td>
</tr>
<tr>
<td>Average number of undergraduate students per class</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Average faculty teaching load in credit hours</td>
<td>$\times 24$</td>
<td></td>
</tr>
<tr>
<td>Total credit hours taught by faculty</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Required full-time faculty (126,000/600)</td>
<td></td>
<td>210</td>
</tr>
<tr>
<td>TA's for projected increase in undergraduate enrollment for 1990–91:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Projected enrollment increase</td>
<td>210</td>
<td></td>
</tr>
<tr>
<td>Average number of credit hours carried by each student</td>
<td>$\times 30$</td>
<td></td>
</tr>
<tr>
<td>Increased number of credit hours</td>
<td>6,300</td>
<td></td>
</tr>
<tr>
<td>Average faculty teaching load</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>One-half carried by TA's</td>
<td>$\times 0.5$</td>
<td></td>
</tr>
<tr>
<td>TA teaching load</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Required number of TA's (6,300/300)</td>
<td></td>
<td>21</td>
</tr>
<tr>
<td><strong>For graduate program</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enrollment for 1990–91 (excluding TA's)</td>
<td>1,365</td>
<td></td>
</tr>
<tr>
<td>Average number of credit hours carried by each student</td>
<td>$\times 24$</td>
<td></td>
</tr>
<tr>
<td>Graduate credit hours (excluding TA's)</td>
<td>32,760</td>
<td></td>
</tr>
<tr>
<td>TA credit hours [$21 \times (\frac{1}{2} \text{ of 24})]$</td>
<td>252</td>
<td></td>
</tr>
<tr>
<td>Total graduate credit hours</td>
<td>33,012</td>
<td></td>
</tr>
<tr>
<td>Average number of students per class</td>
<td>14</td>
<td></td>
</tr>
<tr>
<td>Average faculty teaching load</td>
<td>$\times 18$</td>
<td></td>
</tr>
<tr>
<td>Total credit hours taught by faculty</td>
<td>252</td>
<td></td>
</tr>
<tr>
<td>Required full-time faculty (33,012/252)</td>
<td></td>
<td>131</td>
</tr>
<tr>
<td>Total required full-time faculty and TA's</td>
<td></td>
<td>341</td>
</tr>
</tbody>
</table>

AP-245
Accounting Practice

2M90
Answer 5 (cont.)

a. 4.

Lane College
PROJECTED SALARIES AND BENEFITS
FOR FULL-TIME FACULTY AND TA’S
For the Academic Year 1990–91

<table>
<thead>
<tr>
<th>Faculty</th>
<th>Undergraduate</th>
<th>Graduate</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full-time 210 × ($50,000 × 1.03)</td>
<td>$10,815,000</td>
<td></td>
<td>$10,815,000</td>
</tr>
<tr>
<td>TA’s 21 × $10,000</td>
<td>210,000</td>
<td></td>
<td>210,000</td>
</tr>
<tr>
<td>Full-time 131 × ($60,000 × 1.03)</td>
<td></td>
<td>$8,095,800</td>
<td>8,095,800</td>
</tr>
<tr>
<td>Total salaries and benefits</td>
<td>$11,025,000</td>
<td>$8,095,800</td>
<td>$19,120,800</td>
</tr>
</tbody>
</table>

a. 5.

Lane College
PROJECTED TUITION REVENUE
For the Academic Year 1990–91

Undergraduate
132,300 student credit hours × $200 per credit hour | $26,460,000

Graduate
33,012 student credit hours × $300 per credit hour | 9,903,600
Total projected tuition revenue | $36,363,600

b. 1.

Lane College
FIXED AND VARIABLE ELEMENTS
IN NON-FACULTY COSTS
For the Academic Year 1990–91

Estimated non-faculty costs at level of 180,000 credit hours | $22,320,000
Estimated non-faculty costs at level of 140,000 credit hours | 21,960,000
Difference between two levels | 40,000 | $360,000
Variable costs per credit hour = 360,000/40,000 = $9
Fixed costs = $22,320,000 − $9 (180,000) = $20,700,000
or
$21,960,000 − $9 (140,000) = $20,700,000

b. 2.

Lane College
BUDGETED NON-FACULTY COSTS
For the Academic Year 1990–91

Fixed costs | $20,700,000
Variable costs (165,312 credit hours × $9) | 1,487,808
Scholarships (21 TA’s × 12 credits × $300 per credit) | 75,600
Total budgeted non-faculty costs | $22,263,408

AP-246
Unofficial Answers

2M89
Answer 5 (10 points)

a. Tapa Wholesale Company
PRICING FUNCTION BUDGET
For the Year Ending December 31, 1989

Variable costs:
Wages $66,000
Payroll taxes 6,600
Workers' compensation insurance 3,300
Supplies 1,500
Total variable costs 77,400
Fixed costs 3,400
Total costs $80,800

COMPUTATIONS

Wages
Number of items priced in 1988
(20,000 × 4) 80,000
Projected number of items priced
in 1989 (24,000 × 5) 120,000
Average wage cost per item in 1988
($40,000/80,000) $0.50
Projected wage cost in 1989
(120,000 @ $0.50 + 10%) $66,000

Payroll taxes
$66,000 × 10% $6,600

Workers' compensation insurance
$66,000 × 5% $3,300

Supplies
1989 projected multiple of number of 1988 items
(120,000/80,000) 1.5 times
$1,000 × 1.5 $1,500

b. Tapa Wholesale Company
COMPUTATION OF STANDARD DELIVERY
COST PER UNIT OF PRODUCT
For the Year Ending December 31, 1989

<table>
<thead>
<tr>
<th>Product</th>
<th>Units</th>
<th>Unit capacity per truck</th>
<th>Number of deliveries projected</th>
<th>Variable costs per delivery</th>
<th>Variable costs per unit delivered</th>
<th>Fixed costs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arcil</td>
<td>60,000</td>
<td>10</td>
<td>6,000</td>
<td>$12</td>
<td>$1.20</td>
<td>$0.25</td>
<td>$1.45</td>
</tr>
<tr>
<td>Balo</td>
<td>40,000</td>
<td>5</td>
<td>8,000</td>
<td>12</td>
<td>2.40</td>
<td>0.25</td>
<td>2.65</td>
</tr>
<tr>
<td>Cacha</td>
<td>20,000</td>
<td>4</td>
<td>5,000</td>
<td>12</td>
<td>3.00</td>
<td>0.25</td>
<td>3.25</td>
</tr>
<tr>
<td>Totals</td>
<td>120,000</td>
<td></td>
<td>19,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2M99
Answer 5 (cont.)

Variable cost per delivery:
Total number of deliveries 19,000
Variable costs $228,000
Variable costs per delivery $12

Fixed costs per unit:
Total number of units 120,000
Fixed costs $30,000
Fixed costs per unit $0.25

2N88
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>5/12 = 42%</td>
<td>$42,000</td>
<td>$84,000</td>
<td>$42,000</td>
</tr>
<tr>
<td>Maple</td>
<td>4/12 = 33%</td>
<td>33,000</td>
<td>37,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Spruce</td>
<td>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></th>
<th>Total</th>
<th>Warehouse operations</th>
<th>Store</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before corporation overhead</td>
<td>$150,000</td>
<td></td>
<td>Birch</td>
</tr>
<tr>
<td>Warehouse operations</td>
<td>15,000</td>
<td>$15,000</td>
<td>$84,000</td>
</tr>
<tr>
<td>Central office salaries</td>
<td>30,000</td>
<td>7,500</td>
<td>$37,000</td>
</tr>
<tr>
<td>Other central office overhead</td>
<td>2,000</td>
<td>500</td>
<td>$29,000</td>
</tr>
<tr>
<td>Total warehouse operations</td>
<td>23,000</td>
<td>$23,000</td>
<td></td>
</tr>
<tr>
<td>Warehouse depreciation</td>
<td>10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>8,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total — allocated on basis of sales</td>
<td>41,000</td>
<td>17,220</td>
<td>13,530</td>
</tr>
<tr>
<td>Delivery expenses — allocated on basis of miles times deliveries</td>
<td>35,000</td>
<td>17,500</td>
<td>11,550</td>
</tr>
<tr>
<td>15,000/30,000 = 50%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10,000/30,000 = 33%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5,000/30,000 = 17%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total corporation overhead</td>
<td>100,000</td>
<td>42,720</td>
<td>33,080</td>
</tr>
<tr>
<td>Income after corporation overhead</td>
<td>$50,000</td>
<td>$41,280</td>
<td>$3,920</td>
</tr>
</tbody>
</table>

AP-248
b.   

**Amar Supermarkets Corp.**  
**COMPUTATION OF COST INCREASES**  
**RESULTING FROM PROSPECTIVE INCREASE IN SALES**

<table>
<thead>
<tr>
<th>Store</th>
<th>Birch</th>
<th>Maple</th>
<th>Spruce</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales — 1987</td>
<td>$500,000</td>
<td>$400,000</td>
<td>$300,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Cost of sales — 1987</td>
<td>$280,000</td>
<td>$230,000</td>
<td>$190,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Local variable operating expenses</td>
<td>66,000</td>
<td>73,000</td>
<td>31,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Total local variable costs</td>
<td>$346,000</td>
<td>$303,000</td>
<td>$221,000</td>
<td>$870,000</td>
</tr>
<tr>
<td>Percent of local variable costs to sales</td>
<td>69%</td>
<td>76%</td>
<td>74%</td>
<td></td>
</tr>
<tr>
<td>Multiplied by prospective increase in sales</td>
<td>$80,000</td>
<td>$80,000</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Increase in local variable costs</td>
<td>55,200</td>
<td>60,800</td>
<td>59,200</td>
<td></td>
</tr>
<tr>
<td>Increase in delivery expenses</td>
<td>1,170</td>
<td>2,340</td>
<td>293</td>
<td></td>
</tr>
<tr>
<td>Increase in relevant expenses (local variable costs and delivery)</td>
<td>$56,370</td>
<td>$63,140</td>
<td>$59,493</td>
<td></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>

Cost per delivery mile = Delivery expenses in 1987 / Delivery miles in 1987 = $35,000 / 30,000 = $1.17

2M88  
**Answer 5 (10 points)**

**Seco Corp.**  
**Year Ending December 31, 1989**

a.  
**Estimated Breakeven Point Based on Pro Forma Income Statement**

<table>
<thead>
<tr>
<th>Item</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
<td></td>
</tr>
<tr>
<td>Variable costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>$6,000,000</td>
<td></td>
</tr>
<tr>
<td>Commissions</td>
<td>2,000,000</td>
<td></td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$2,000,000</td>
<td></td>
</tr>
<tr>
<td>Contribution margin ratio ($2,000,000 / $10,000,000)</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Contribution margin ratio</td>
<td>+ .20</td>
<td></td>
</tr>
<tr>
<td>Estimated breakeven point</td>
<td>$500,000</td>
<td></td>
</tr>
</tbody>
</table>

AP-249
b. Estimated Breakeven Point With Company Employing Its Own Salespersons

Variable cost ratios
- Cost of sales: 60%
- Commissions: 5%
- Total: 65%

Contribution margin ratio (100% - 65%): 35%

Fixed costs
- Sales manager: $160,000
- 3 salespersons @ $30,000 each: $90,000
- Administrative: $100,000
- Total: $350,000

Contribution margin ratio: + .35

Estimated breakeven point: $1,000,000

c. Estimated Sales Volume Yielding Net Income
Projected in Pro Forma Income Statement
With Independent Sales Agents Receiving 25% Commission

Target income before income tax: $1,900,000
Fixed costs: $100,000
Total: $2,000,000

Variable cost ratios
- Cost of sales: 60%
- Commissions: 25%
- Total: 85%

Contribution margin ratio (100% - 85%): 15%

Target income + fixed costs: $2,000,000
Contribution margin ratio: + .15
Estimated sales volume: $13,333,333
d. Estimated Sales Volume Yielding An Identical Net Income
Regardless of Whether the Company Employs Its Own Salespersons
or Continues With Independent Sales Agents and Pays Them 25% Commission

Total costs with agents receiving 25% commission = Total costs with company’s own sales force

\[
X = \frac{8,500,000}{10,000,000}X + \frac{100,000}{10,000,000} = X + \frac{6,500,000}{10,000,000}X + \frac{350,000}{10,000,000}
\]

\[
.85X + \frac{100,000}{10,000,000} = .65X + \frac{350,000}{10,000,000}
\]

\[
.20X = \frac{250,000}{10,000,000}
\]

\[
X = \frac{1,250,000}{10,000,000}
\]

2N87
Answer 4 (10 points)

Webb & Company
March 1987

a. (1) **Equivalent Units**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returns completed</td>
<td>900</td>
<td>900</td>
</tr>
<tr>
<td>Returns in process, 3/31</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Equivalent units</td>
<td>1,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

(2) **Actual Cost Per Equivalent Unit**

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of returns in process, 3/1</td>
<td>$6,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Add: March costs</td>
<td>89,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Total 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**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor (125 returns × 80% × $95.00)</td>
<td>$9,500</td>
</tr>
<tr>
<td>Overhead (125 returns × 80% × $47.50)</td>
<td>4,750</td>
</tr>
<tr>
<td>Total</td>
<td>$14,250</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><strong>Total</strong></td>
<td>$150</td>
<td></td>
</tr>
</tbody>
</table>

d. **Analysis of March Performance**

1. Total labor variance (actual minus standard)
   \[ \$89,000 - (950 \times \$100) = $6,000 \text{ favorable} \]
2. Labor rate variance
   \[ \frac{\$89,000 - 4,000 \times \$20}{4,000} = $9,000 \text{ unfavorable} \]
3. Labor efficiency variance
   \[ 4,000 - (950 \times 5) \times \$20 = $15,000 \text{ favorable} \]
4. Total overhead variance (actual minus standard)
   \[ \$45,000 - (950 \times \$50) = $2,500 \text{ favorable} \]
5. Overhead volume variance
   \[ \$49,000 - (950 \times \$50) = $1,500 \text{ unfavorable} \]
6. Overhead budget variance
   \[ \$45,000 - $49,000 = $4,000 \text{ favorable} \]

---

*Equivalent units (weighted average method)*

<table>
<thead>
<tr>
<th></th>
<th>Labor</th>
<th>Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equivalent units</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Less equivalent units</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Beginning inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(25% \times 200)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equivalent units</td>
<td>950</td>
<td>950</td>
</tr>
</tbody>
</table>
Unofficial Answers

VIII. Not-for-Profit and Governmental Accounting

Candidate’s No. ________________________
State ________________________
Question No. 4 Page ________________

Albury City

WORKSHEET TO CORRECT TRIAL BALANCE

December 31, 1990

<table>
<thead>
<tr>
<th></th>
<th>Trial balance</th>
<th>Adjustments</th>
<th>General fund</th>
<th>Debt service fund</th>
<th>Capital projects fund</th>
<th>Account groups</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Debit</td>
<td>Credit</td>
<td></td>
<td></td>
<td>General fixed assets</td>
</tr>
<tr>
<td>Debits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$477,800</td>
<td>$71,800</td>
<td>$6,000</td>
<td>$400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures</td>
<td>145,000</td>
<td>$28,000 [b]</td>
<td>173,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated revenues</td>
<td>228,200</td>
<td></td>
<td>228,200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>66,000 [c]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$66,000</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>10,000 [d]</td>
<td></td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supplies inventory</td>
<td>3,400 [e]</td>
<td></td>
<td>3,400</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes receivable—current</td>
<td>24,000 [a]</td>
<td></td>
<td>24,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount to be provided for retirement of term bonds</td>
<td>394,000 [g]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$394,000</td>
</tr>
<tr>
<td>Amounts available in debt service fund—term bonds</td>
<td>6,000 [g]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$851,000</td>
<td></td>
<td>$510,400</td>
<td>$6,000</td>
<td>$400,000</td>
<td>$66,000</td>
</tr>
<tr>
<td>Credits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appropriations</td>
<td>$204,000</td>
<td></td>
<td>$204,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues and other financing sources</td>
<td>216,800</td>
<td>$13,200 [a]</td>
<td>230,000</td>
<td>$6,000</td>
<td>$400,000</td>
<td></td>
</tr>
<tr>
<td>Bonds payable</td>
<td>400,000</td>
<td>400,000 [f]</td>
<td>400,000 [g]</td>
<td></td>
<td></td>
<td>$400,000</td>
</tr>
<tr>
<td>Premium on bonds payable</td>
<td>6,000</td>
<td>6,000 [f]</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund balance</td>
<td>24,200</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td></td>
<td>28,000 [b]</td>
<td>28,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in general fixed assets—general fund revenue</td>
<td>66,000 [c]</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$66,000</td>
</tr>
<tr>
<td>Reserved for encumbrances</td>
<td>10,000 [d]</td>
<td></td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserved for supplies inventory</td>
<td>3,400 [e]</td>
<td></td>
<td>3,400</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated uncollectible current taxes</td>
<td>10,800 [a]</td>
<td></td>
<td>10,800</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$851,000</td>
<td>$937,000</td>
<td>$937,400</td>
<td>$510,400</td>
<td>$6,000</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

AP-253
**Albury City**  
**WORKSHEET ADJUSTMENTS**  
**December 31, 1990**  
(Not Required)

<table>
<thead>
<tr>
<th>[a]</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxes receivable — current</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Estimated uncollectible current taxes</td>
<td>$ 24,000</td>
<td>$ 10,800</td>
</tr>
<tr>
<td></td>
<td>Revenues</td>
<td></td>
<td>13,200</td>
</tr>
<tr>
<td></td>
<td>To record current taxes receivable and amount estimated as uncollectible, computed as follows:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total tax levy</td>
<td>$205,200</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Divided by % collectible</td>
<td>.95</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Taxes receivable = $216,000 - $192,000</td>
<td>$ 24,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Estimated uncollectible taxes = 5% x $216,000</td>
<td></td>
<td>$ 10,800</td>
</tr>
<tr>
<td>[b]</td>
<td>Expenditures</td>
<td>28,000</td>
<td>28,000</td>
</tr>
<tr>
<td></td>
<td>Vouchers payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record liabilities unrecorded at year-end.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[c]</td>
<td>Equipment</td>
<td>66,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Investment in general fixed assets — general fund revenue</td>
<td></td>
<td>66,000</td>
</tr>
<tr>
<td></td>
<td>To record purchase of equipment from general fund revenue.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[d]</td>
<td>Encumbrances</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserved for encumbrances</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>To record purchase orders outstanding at year-end.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[e]</td>
<td>Supplies inventory</td>
<td>3,400</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reserved for supplies inventory</td>
<td></td>
<td>3,400</td>
</tr>
<tr>
<td></td>
<td>To record inventory of supplies on hand at year-end.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[f]</td>
<td>Bonds payable</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Premium on bonds payable</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other financing sources</td>
<td></td>
<td>406,000</td>
</tr>
<tr>
<td></td>
<td>To reclassify bond proceeds.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>[g]</td>
<td>Amount to be provided for retirement of term bonds</td>
<td>394,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Amounts available in debt service fund — term bonds</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bonds payable</td>
<td></td>
<td>400,000</td>
</tr>
<tr>
<td></td>
<td>To record bond issue and amount restricted for bond retirement.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## JOURNAL ENTRIES

For the Year Ended June 30, 1989

<table>
<thead>
<tr>
<th>Account Title</th>
<th>Current Fund</th>
<th>Land, Buildings, and Equipment Fund</th>
<th>Endowment Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unrestricted</td>
<td>Restricted</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dr. (Cr.)</td>
<td>Dr. (Cr.)</td>
<td></td>
</tr>
<tr>
<td>1. Pledges receivable</td>
<td>$800,000</td>
<td>$95,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>(800,000)</td>
<td>(95,000)</td>
<td></td>
</tr>
<tr>
<td>2. Cash</td>
<td>450,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Pledges receivable</td>
<td>(450,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Cash</td>
<td>35,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special events support</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legacies and bequests</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Membership dues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Medical services program</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Community information services program</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Management and general services</td>
<td>150,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund-raising services</td>
<td>200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vouchers payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Transfer to land, buildings, and</td>
<td>18,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>equipment fund</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(18,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings and equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund balance — expended</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund balance — unexpended</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Depreciation expense</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund-balance — expended</td>
<td>15,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund balance — unexpended</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical services program</td>
<td>4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Community information services program</td>
<td>3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management and general services</td>
<td>6,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fund raising services</td>
<td>2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Vouchers payable</td>
<td>330,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>(330,000)</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>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(2)</td>
<td></td>
<td>40,000</td>
<td></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(3)</td>
<td></td>
<td>746,000</td>
<td></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(1)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other fund balances</td>
<td>1,100,000</td>
<td>1,100,000(6)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Account</td>
<td>Trial Balance December 31, 1986</td>
<td>Adjustments</td>
<td>General (Unrestricted) Funds</td>
<td>Endowment Fund</td>
<td>Plant Replacement and Expansion Fund</td>
</tr>
<tr>
<td>----------------------------------------------</td>
<td>---------------------------------</td>
<td>-------------</td>
<td>-------------------------------</td>
<td>----------------</td>
<td>-------------------------------------</td>
</tr>
<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>246,000(4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due to plant replacement and expansion fund</td>
<td></td>
<td></td>
<td>246,000(5)</td>
<td>246,000(6)</td>
<td></td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td></td>
<td></td>
<td>246,000(4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
<td></td>
<td>60,000(2)</td>
<td>120,000(1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>336,000(3)</td>
<td>600,000(6)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>246,000(5)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>2,120,000</td>
<td>2,120,000</td>
<td>2,108,000</td>
<td>2,108,000</td>
<td>1,160,000</td>
</tr>
</tbody>
</table>
Esperanza Hospital  
**ADJUSTING JOURNAL ENTRIES**  
January 1, 1987  

*(Not Required)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Endowment fund balance</td>
<td>120,000</td>
<td>120,000</td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) To transfer investment income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) To eliminate appreciation in land value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>336,000</td>
<td>336,000</td>
</tr>
<tr>
<td>Allowance for depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4) To correct allowance for depreciation account as follows:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building — $720,000 × 2% × 40 years</td>
<td>$576,000</td>
<td></td>
</tr>
<tr>
<td>Elevator — 80,000 × 5% × 20 years</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Equipment (correctly computed)</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Correct allowance for depreciation</td>
<td>746,000</td>
<td></td>
</tr>
<tr>
<td>Balance per books</td>
<td>410,000</td>
<td></td>
</tr>
<tr>
<td>Understatement</td>
<td>$336,000</td>
<td></td>
</tr>
<tr>
<td>(4) Due from general (unrestricted) funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td>246,000</td>
<td>246,000</td>
</tr>
<tr>
<td>Adjusted allowance for depreciation</td>
<td>$746,000</td>
<td></td>
</tr>
<tr>
<td>Investment in corporate bonds</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Underfunded for asset replacement</td>
<td>$246,000</td>
<td></td>
</tr>
<tr>
<td>(5) General (unrestricted) funds balance</td>
<td>246,000</td>
<td></td>
</tr>
<tr>
<td>Due to plant replacement and expansion fund</td>
<td>246,000</td>
<td></td>
</tr>
<tr>
<td>(6) Other fund balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant replacement and expansion fund balance</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>General (unrestricted) funds balance</td>
<td>600,000</td>
<td></td>
</tr>
<tr>
<td>To allocate other fund balances</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AP-258
a. Earl Mayne can use joint return rates in computing his 1989 federal income tax because he qualifies as a "surviving spouse."

b.  

**Earl Mayne**

**COMPUTATION OF TAXABLE INCOME**  
For the Year Ended December 31, 1989

<table>
<thead>
<tr>
<th>Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries ($60,000 + $3,000)</td>
<td>$63,000</td>
</tr>
<tr>
<td>Interest</td>
<td>800</td>
</tr>
<tr>
<td>Dividends</td>
<td>875</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td></td>
</tr>
<tr>
<td>Nonbusiness bad debt</td>
<td>$2,500</td>
</tr>
<tr>
<td>Settlement proceeds</td>
<td>350</td>
</tr>
<tr>
<td>Balance</td>
<td>(2,150)</td>
</tr>
<tr>
<td>Proceeds from sale of residence</td>
<td>97,402</td>
</tr>
<tr>
<td>Less basis</td>
<td>14,000</td>
</tr>
<tr>
<td>Gain</td>
<td>83,402</td>
</tr>
<tr>
<td>Exclusion</td>
<td>83,402</td>
</tr>
<tr>
<td>Balance</td>
<td>-0-</td>
</tr>
<tr>
<td>Gross rents</td>
<td>1,200</td>
</tr>
<tr>
<td>Less realty expenses</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>(800)</td>
</tr>
<tr>
<td>Passive activity disallowance</td>
<td>800</td>
</tr>
<tr>
<td>Balance</td>
<td>-0-</td>
</tr>
<tr>
<td>Other exclusions from gross income</td>
<td></td>
</tr>
<tr>
<td>Life insurance proceeds</td>
<td>5,000</td>
</tr>
<tr>
<td>Dividends on life insurance policy</td>
<td>410</td>
</tr>
<tr>
<td>Total</td>
<td>5,410</td>
</tr>
<tr>
<td>Adjusted gross income</td>
<td>62,525</td>
</tr>
</tbody>
</table>

**Unofficial Answers**

IX. Federal Taxation—Individuals, Estates, and Trusts

2M90

Answer 4 (10 points)

a. Earl Mayne can use joint return rates in computing his 1989 federal income tax because he qualifies as a "surviving spouse."

b.
Accounting Practice

2009
Answer 4 (cont.)

**Itemized deductions**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>State income tax</td>
<td>$2,000</td>
</tr>
<tr>
<td>Real estate tax</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$3,500</td>
</tr>
<tr>
<td>Contributions</td>
<td>2,250</td>
</tr>
<tr>
<td>Miscellaneous deductions</td>
<td></td>
</tr>
<tr>
<td>Professional education</td>
<td>900</td>
</tr>
<tr>
<td>Professional dues</td>
<td>250</td>
</tr>
<tr>
<td>Tax return preparation fee</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,650</td>
</tr>
<tr>
<td>Less 2% of $62,525</td>
<td>1,251</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td>399</td>
</tr>
<tr>
<td>Total itemized deductions</td>
<td></td>
</tr>
<tr>
<td>Balance</td>
<td>6,149</td>
</tr>
<tr>
<td>Exemptions (3 × $2,000)</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>TAXABLE INCOME</strong></td>
<td>$50,376</td>
</tr>
</tbody>
</table>

**c. COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax before payments on account</td>
<td>$10,082</td>
</tr>
<tr>
<td>Payments on account</td>
<td></td>
</tr>
<tr>
<td>Tax withheld ($10,000 + $100)</td>
<td>$10,100</td>
</tr>
<tr>
<td>Excess FICA tax</td>
<td>225</td>
</tr>
<tr>
<td>Estimated tax ($4,000 + $70)</td>
<td>4,070</td>
</tr>
<tr>
<td><strong>OVERPAYMENT</strong></td>
<td>$4,313</td>
</tr>
</tbody>
</table>
Fred and Laura Shaw  
COMPUTATION OF TAXABLE INCOME  
For the Year Ended December 31, 1988

Income
Salary — Fred $80,000  
Salary — Laura 15,000  
Interest 100  
Dividends 527  
Social security benefits (½ of $12,000) 6,000  
Unemployment compensation 600  
Long-term capital loss (Basis $9,000; sales price $2,500; allowable loss limited to $3,000) (3,000)

Adjusted gross income 99,227

Itemized deductions
Taxes
State income taxes ($4,000 + $120) $4,120  
Real estate taxes ($3,000 + $800) 3,800 $7,920  
Interest ($2,300 + $1,800) 4,100  
Contributions (fair market value) 1,400  
Casualty loss
Decline in market value after fire 16,000  
Less 10% of $99,227 $9,923  
“Floor” 100  
10,023  
5,977

Miscellaneous deductions
Business travel 900  
Professional education 700  
Professional dues 150  
Tax return preparation fee 250  
Total 2,000  
Less 2% of $99,227 1,985  
15

Total itemized deductions 19,412

Balance 79,815  
Exemptions (3 x $1,950) 5,850

TAXABLE INCOME $73,965

b.  
COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT

Tax before payments on account $16,946
Payments on account
Tax withheld ($17,000 + $2,800) $19,800  
Estimated tax ($2,000 + $43) 2,043  
21,843

AMOUNT OVERPAID $4,897

AP-261
Ann Ford

PROJECTED RECEIPTS AND EXPENDITURES
WITH NO EFFECT ON TAXABLE INCOME
1987

Receipts | Expenditures
---|---
Federal income tax ($9,000 + $300 + $5,000) | $14,300
FICA tax ($3,132 + $215) | 3,347
Bequest under husband's will | $25,000
Life insurance proceeds on husband's death | 15,000
Food, clothing, household, and miscellaneous | 20,000
State inheritance tax | 2,100
City and state sales taxes | 1,100
Auto license and registration | 50
Political contribution | 100

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

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 | 14,515
Amount overpaid | $ 2,094

AP-262
Unofficial Answers

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

2NF0
Answer 4 (10 points)

<table>
<thead>
<tr>
<th>Income</th>
<th>Per books</th>
<th>Adjustments</th>
<th>S Corporation tax return</th>
<th>Schedule K-1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>500,000</td>
<td></td>
<td>500,000</td>
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</tr>
<tr>
<td>Cost of goods sold</td>
<td>300,000</td>
<td></td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>200,000</td>
<td></td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td><strong>Deductions</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation of officer</td>
<td>90,000</td>
<td></td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>7,000</td>
<td>(5,100)</td>
<td>1,900</td>
<td>2,200</td>
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<tr>
<td>Taxes</td>
<td>25,000</td>
<td>(2,600)</td>
<td>22,400</td>
<td>22,400</td>
</tr>
<tr>
<td>Depreciation</td>
<td>14,000</td>
<td>(10,000)</td>
<td>4,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Contributions</td>
<td>5,000</td>
<td>(5,000)</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Employee benefit programs</td>
<td>19,000</td>
<td>(6,000)</td>
<td>13,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Amortization of organization costs</td>
<td>300</td>
<td></td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>20,700</td>
<td>(8,000)</td>
<td>12,700</td>
<td></td>
</tr>
<tr>
<td><strong>Total deductions</strong></td>
<td>181,000</td>
<td>(36,700)</td>
<td>144,300</td>
<td></td>
</tr>
<tr>
<td>Operating income</td>
<td>19,000</td>
<td>36,700</td>
<td>55,700</td>
<td>55,700</td>
</tr>
<tr>
<td>Net rental revenue</td>
<td>18,000</td>
<td></td>
<td>18,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Portfolio revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>5,600</td>
<td></td>
<td>5,600</td>
<td>5,600</td>
</tr>
<tr>
<td>Dividends</td>
<td>3,000</td>
<td></td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>9,000</td>
<td></td>
<td>9,000</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total income</strong></td>
<td>54,600</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Elm Corp.**

**FEDERAL TAXABLE INCOME**

*For the Year Ended December 31, 1988*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (net)</td>
<td>$5,500,000</td>
<td>[1]</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>3,900,000</td>
<td>[8]</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1,600,000</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Other income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>From partnership</td>
<td>$63,000</td>
<td>[5]</td>
</tr>
<tr>
<td>Recapture of bad debt reserve</td>
<td>30,000</td>
<td>[10]</td>
</tr>
<tr>
<td>Total income</td>
<td>1,703,000</td>
<td></td>
</tr>
<tr>
<td>Compensation of officers</td>
<td>125,000</td>
<td>[9]</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>446,000</td>
<td>[9]</td>
</tr>
<tr>
<td>Bad debts</td>
<td>9,000</td>
<td>[10]</td>
</tr>
<tr>
<td>Taxes</td>
<td>100,000</td>
<td>[11]</td>
</tr>
<tr>
<td>Interest</td>
<td>20,000</td>
<td>[12]</td>
</tr>
<tr>
<td>Contributions</td>
<td>89,500</td>
<td>[13]</td>
</tr>
<tr>
<td>Depreciation</td>
<td>90,000</td>
<td>[14]</td>
</tr>
<tr>
<td>Other deductions</td>
<td>18,000</td>
<td>[15]</td>
</tr>
<tr>
<td>Total deductions</td>
<td>897,500</td>
<td></td>
</tr>
<tr>
<td>Taxable income before special deduction</td>
<td>805,500</td>
<td>[11]</td>
</tr>
<tr>
<td>Special deduction</td>
<td>7,000</td>
<td>[2]</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$798,500</td>
<td></td>
</tr>
</tbody>
</table>

**EXPLANATIONS AND COMPUTATIONS**

1. Net sales — no adjustment.
2. Dividends — $10,000 × 70% dividends-received deduction = $7,000.
3. Interest — not taxable.
5. Equity in earnings of Luz Partnership — $50,000 + $13,000 = $63,000.
6. Key-man life insurance proceeds — not taxable.
7. Tax refund — not taxable.
8. Cost of goods sold — no adjustment.
9. Salaries and wages — separate $125,000 officers' compensation.
10. Doubtful accounts — limited to $9,000 actual bad debts. One-fourth of $120,000 "reserve" at December 31, 1986 = $30,000 income.
11. Taxes — no adjustment.
12. Interest — no adjustment.
13. Contributions:
   - Taxable income $798,500
   - Dividends-received deduction 7,000
   - Contributions deduction 89,500
   - Total 895,000
   - Allowable — 10% $89,500
15. Other — $30,000 less $12,000 life insurance premiums = $18,000.
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<td>*</td>
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<td>*</td>
<td>*</td>
</tr>
<tr>
<td>C. Basic Concepts and Accounting Principles</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>D. Nature and Purpose of Basic Financial Statements</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>E. Consolidated Financial Statements</td>
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<td></td>
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<td>C. Inventories</td>
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<table>
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</tr>
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<td></td>
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<td></td>
</tr>
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<td></td>
</tr>
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</tr>
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<table>
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<td></td>
</tr>
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<td>T-17</td>
<td></td>
</tr>
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<td>E. Stock Options, Warrants, and Rights</td>
<td>*</td>
<td></td>
</tr>
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<td>F. Reorganization and Change in Entity</td>
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<td></td>
</tr>
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<td>G. Partnerships</td>
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</tbody>
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† Questions in this area are not classified according to group.
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<th></th>
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<td>F. Interim Financial Statements</td>
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<td>K. Development Stage Enterprises</td>
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<td>T-33</td>
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<tr>
<td>M. Combined Financial Statements</td>
<td>T-34</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
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<td>T-35</td>
</tr>
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<td>B. Process and Job Order Costing</td>
<td>T-35</td>
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<td>C. Standard Costing</td>
<td>T-36</td>
</tr>
<tr>
<td>D. Joint and By-Product Costing, Spoilage, Waste, and Scrap</td>
<td>T-37</td>
</tr>
<tr>
<td>E. Absorption and Variable Costing</td>
<td>T-38</td>
</tr>
<tr>
<td>F. Budgeting and Flexible Budgeting</td>
<td>T-39</td>
</tr>
<tr>
<td>G. Breakeven and Cost-Volume-Profit Analysis</td>
<td>T-40</td>
</tr>
<tr>
<td>H. Capital Budgeting Techniques</td>
<td>T-41</td>
</tr>
<tr>
<td>I. Performance Analysis</td>
<td>T-42</td>
</tr>
<tr>
<td>J. Other</td>
<td>T-42</td>
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<table>
<thead>
<tr>
<th>VIII. Not-for-Profit and Governmental Accounting</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Conceptual Framework</td>
<td>T-44</td>
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<tr>
<td>B. Fund Accounting</td>
<td>T-44</td>
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<tr>
<td>C. Types of Funds and Account Groups</td>
<td>T-46</td>
</tr>
<tr>
<td>D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations</td>
<td>T-49</td>
</tr>
<tr>
<td>E. Various Types of Not-for-Profit and Governmental Organizations</td>
<td>T-50</td>
</tr>
</tbody>
</table>

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I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework

M91#1. Under FASB Statement of Financial Accounting Concepts No. 5, which of the following items would cause earnings to differ from comprehensive income for an enterprise in an industry not having specialized accounting principles?
1. Unrealized loss on investments in noncurrent marketable equity securities.
2. Unrealized loss on investments in current marketable equity securities.
3. Loss on exchange of similar assets.
4. Loss on exchange of dissimilar assets.

N90#1. According to the FASB’s conceptual framework, the process of reporting an item in the financial statements of an entity is
1. Recognition.
2. Realization.
3. Allocation.
4. Matching.

M90#1. According to the FASB conceptual framework, predictive value is an ingredient of

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Reliability</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N90#1. According to the FASB’s conceptual framework, comprehensive income includes which of the following?

<table>
<thead>
<tr>
<th>Operating income</th>
<th>Investments by owners</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#1. According to the FASB’s conceptual framework, asset valuation accounts are
1. Assets.
2. Neither assets nor liabilities.
3. Part of stockholders’ equity.
4. Liabilities.

M88#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>

M88#2. The FASB’s conceptual framework classifies gains and losses based on whether they are related to an entity’s major ongoing or central operations. These gains or losses may be classified as

<table>
<thead>
<tr>
<th>Nonoperating</th>
<th>Operating</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. Consolidated Financial Statements

N90#2. Water Co. owns 80% of the outstanding common stock of Fire Co. On December 31, 1989, Fire sold equipment to Water at a price in excess of Fire’s
carrying amount, but less than its original cost. On a consolidated balance sheet at December 31, 1989, the carrying amount of the equipment should be reported at

a. Water's original cost.
b. Fire's original cost.
c. Water's original cost less Fire's recorded gain.
d. Water's original cost less 80% of Fire's recorded gain.

**M90#2.** P Co. purchased term bonds at a premium on the open market. These bonds represented 20 percent of the outstanding class of bonds issued at a discount by S Co., P's wholly owned subsidiary. P intends to hold the bonds until maturity. In a consolidated balance sheet, the difference between the bond carrying amounts in the two companies would be

a. Included as a decrease to retained earnings.
b. Included as an increase to retained earnings.
c. Reported as a deferred debit to be amortized over the remaining life of the bonds.
d. Reported as a deferred credit to be amortized over the remaining life of the bonds.

**M88#3.** A subsidiary was acquired for cash in a business combination on January 1, 1987. The purchase price exceeded the fair value of identifiable net assets. The acquired company owned equipment with a market value in excess of the carrying amount as of the date of combination. A consolidated balance sheet prepared on December 31, 1987, would

a. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of goodwill.
b. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
c. Report the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
d. Not report the excess of the market value over the carrying amount of the equipment because it would be expensed as incurred.

**F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts**

**M91#2.** Could current cost financial statements report holding gains for goods sold during the period and holding gains on inventory at the end of the period?

<table>
<thead>
<tr>
<th>Goods sold</th>
<th>Inventory</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>

**M91#3.** When computing purchasing power gain or loss on net monetary items, which of the following accounts is classified as nonmonetary?

a. Unamortized premium on bonds payable.
b. Accumulated depreciation of equipment.
c. Advances to unconsolidated subsidiaries.
d. Allowance for uncollectible accounts.

**M90#11.** During a period of inflation, an account balance remains constant. When supplemental statements are being prepared, a purchasing power gain is reported if the account is a

a. Monetary asset.
b. Monetary liability.
c. Nonmonetary asset.
d. Nonmonetary liability.

**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>
Selected Questions

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

A. Cash, Marketable Securities, and Investments

N91#4. An investor purchased a bond classified as a long-term investment between interest dates at a discount. At the purchase date, the carrying amount of the bond is more than the

<table>
<thead>
<tr>
<th>Cash paid to seller</th>
<th>Face amount of bond</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>

N90#6. On December 29, 1989, BJ Co. sold a marketable equity security that had been purchased on January 4, 1988. BJ owned no other marketable equity security. An unrealized loss was reported in the 1988 income statement. A realized gain was reported in the 1989 income statement. Was the marketable equity security classified as a noncurrent asset and did its 1988 market price decline exceed its 1989 market price recovery?

<table>
<thead>
<tr>
<th>1988 market price decline exceeded 1989 market price recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
</tr>
<tr>
<td>b. Yes</td>
</tr>
<tr>
<td>c. No</td>
</tr>
<tr>
<td>d. No</td>
</tr>
</tbody>
</table>

N90#4. When the market value of an investment in debt securities exceeds its carrying amount, how should each of the following assets be reported at the end of the year?

<table>
<thead>
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<th>Short-term marketable debt securities</th>
<th>Long-term marketable debt securities</th>
</tr>
</thead>
<tbody>
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<td>a. Market value</td>
<td>Market value</td>
</tr>
<tr>
<td>b. Carrying amount</td>
<td>Carrying amount</td>
</tr>
<tr>
<td>c. Carrying amount</td>
<td>Market value</td>
</tr>
<tr>
<td>d. Market value</td>
<td>Carrying amount</td>
</tr>
</tbody>
</table>

N89#2. Robin Co. has a marketable equity securities portfolio classified as noncurrent. None of the holdings enables Robin to exercise significant influence over an investee. The aggregate cost exceeds its aggregate market value. The decline is considered temporary and should be reported as (a) an

a. Unrealized loss in the income statement.
b. Realized loss in the income statement.
c. Valuation allowance in the noncurrent liability section of the balance sheet.
d. Valuation allowance in the asset section of the balance sheet.

N89#3. An investor purchased a bond as a long-term investment on January 2. The investor's carrying value at the end of the first year would be highest if the bond was purchased at a

a. Discount and amortized by the straight-line method.
b. Discount and amortized by the effective interest method.
c. Premium and amortized by the straight-line method.
d. Premium and amortized by the effective interest method.

N89#4. An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

<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. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N89#5. On January 2, 1985, a company established a sinking fund in connection with an issue of bonds due in 1995. At December 31, 1988, the independent trustee held cash in the sinking fund account representing the annual deposits to the fund and the interest earned on those deposits. How should the sinking fund be reported in the company's classified balance sheet at December 31, 1988?

a. The entire balance in the sinking fund account should appear as a noncurrent asset.
b. The entire balance in the sinking fund account should appear as a current asset.
c. The cash in the sinking fund account should appear as a current asset.
d. The accumulated deposits only should appear as a noncurrent asset.

N86#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

<table>
<thead>
<tr>
<th>As a current asset</th>
<th>In an unclassified balance sheet</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>

N89#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.

M88#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.

M88#5. An investor uses the equity method to account for an investment in common stock. After the date of acquisition, the investment account of the investor would
a. Not be affected by its share of the earnings or losses of the investee.
b. Not be affected by its share of the earnings of the investee, but be decreased by its share of the losses of the investee.
c. Be increased by its share of the earnings of the investee, but not be affected by its share of the losses of the investee.
d. Be increased by its share of the earnings of the investee, and decreased by its share of the losses of the investee.

M88#5. The amount by which the aggregate market value of a marketable equity securities portfolio exceeds its cost should be accounted for as a valuation allowance when the portfolio is classified as

<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#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>

B. Receivables and Accruals

M91#10. Gibbs Co. uses the allowance method for recognizing uncollectible accounts. Ignoring deferred taxes, the entry to record the write-off of a specific uncollectible account
a. Affects neither net income nor working capital.
b. Affects neither net income nor accounts receivable.
c. Decreases both net income and accounts receivable.
d. Decreases both net income and working capital.

M91#21. Shep Co. has a receivable from its parent, Pep Co. Should this receivable be separately reported in Shep's balance sheet and in Pep's consolidated balance sheet?

<table>
<thead>
<tr>
<th>Shep's balance sheet</th>
<th>Pep's consolidated balance sheet</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>

M99#6. On July 1, 1988, a company obtained a two-year 8% note receivable for services rendered. At that time the market rate of interest was 10%. The face amount of the note and the entire amount of the interest are due on June 30, 1990. Interest receivable at December 31, 1988, was
a. 5% of the face value of the note.
b. 4% of the face value of the note.
selected questions

c. 5% of the July 1, 1988, present value of the amount due June 30, 1990.
d. 4% of the July 1, 1988, present value of the amount due June 30, 1990.

N89#7. A method of estimating uncollectible accounts that emphasizes asset valuation rather than income measurement is the allowance method based on
a. Aging the receivables.
b. Direct write off.
c. Gross sales.
d. Credit sales less returns and allowances.

N89#2. Which of the following is a method to generate cash from accounts receivable?

<table>
<thead>
<tr>
<th>Assignment</th>
<th>Factoring</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>

N89#3. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. At the date of the discounting transaction, the notes receivable discounted account should be
a. Decreased by the proceeds from the discounting transaction.
b. Increased by the proceeds from the discounting transaction.
c. Increased by the face amount of the note.
d. Decreased by the face amount of the note.

N87#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

N87#4. When the allowance method of recognizing bad debt expense is used, the allowance for doubtful accounts would decrease when a(n)
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.

C. Inventories

N90#15. How should the following costs affect a retailer's inventory?

<table>
<thead>
<tr>
<th>Freight in</th>
<th>Interest on inventory loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

N90#16. The retail inventory method includes which of the following in the calculation of both cost and retail amounts of goods available for sale?

a. Purchase returns.
b. Sales returns.
c. Net markups.
d. Freight in.

N90#17. The replacement cost of an inventory item is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventory item is below the net realizable value less the normal profit margin. Under the lower of cost or market method, the inventory item should be valued at
a. Net realizable value.
b. Net realizable value less the normal profit margin.
c. Original cost.
d. Replacement cost.

N89#8. Shipping costs incurred by a consignor on transfer of goods to a consignee should be considered as
a. Expense to the consignee.
b. Expense to the consignor.
c. Inventory cost to the consignee.
d. Inventory cost to the consignor.

N89#9. The UNO Company was formed on January 2, 1987, to sell a single product. Over a two-year period, UNO's acquisition costs have increased steadily. Physical quantities held in inventory were equal to three months' sales at December 31, 1987, and zero at December 31, 1988. Assuming the periodic inventory system, the inventory cost method which reports the highest amount for each of the following is

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Cost of sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1987</td>
<td>1988</td>
</tr>
<tr>
<td>a. LIFO</td>
<td>FIFO</td>
</tr>
<tr>
<td>b. LIFO</td>
<td>LIFO</td>
</tr>
<tr>
<td>c. FIFO</td>
<td>FIFO</td>
</tr>
<tr>
<td>d. FIFO</td>
<td>LIFO</td>
</tr>
</tbody>
</table>

T-5
Accounting Theory

N86#10. The original cost of an inventory item is above the replacement cost and the net realizable value. The replacement cost is below the net realizable value less the normal profit margin. As a result, the lower of cost or market method, the inventory item should be reported at the
a. Net realizable value.
b. Net realizable value less the normal profit margin.
c. Replacement cost.
d. Original cost.

N86#6. According to the net method, which of the following items should be included in the cost of inventory?

<table>
<thead>
<tr>
<th>Freight costs</th>
<th>Purchase discounts not taken</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#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?

<table>
<thead>
<tr>
<th>FIFO</th>
<th>LIFO</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#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.

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.

N90#13. A building suffered uninsured water and related damage. The damaged portion of the building was refurbished with upgraded materials. The cost and related accumulated depreciation of the damaged portion are identifiable. To account for these events, the owner should
a. Capitalize the cost of refurbishing and record a loss in the current period equal to the carrying amount of the damaged portion of the building.
b. Capitalize the cost of refurbishing by adding the cost to the carrying amount of the building.
c. Record a loss in the current period equal to the cost of refurbishing and continue to depreciate the original cost of the building.
d. Record a loss in the current period equal to the sum of the cost of refurbishing and the carrying amount of the damaged portion of the building.

N90#5. Land was purchased to be used as the site for the construction of a plant. A building on the property was sold and removed by the buyer so that construction on the plant could begin. The proceeds from the sale of the building should be
a. Classified as other income.
b. Deducted from the cost of the land.
c. Netted against the costs to clear the land and expensed as incurred.
d. Netted against the costs to clear the land and amortized over the life of the plant.
Selected Questions

M89#4. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

<table>
<thead>
<tr>
<th></th>
<th>Straight-line</th>
<th>Productive output</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>

M89#5. A lessee incurred costs to construct office space in a leased warehouse. The estimated useful life of the office is ten years. The remaining term of the nonrenewable lease is fifteen years. The costs should be

a. Capitalized as leasehold improvements and depreciated over fifteen years.

b. Capitalized as leasehold improvements and depreciated over ten years.

c. Capitalized as leasehold improvements and expensed in the year in which the lease expires.

d. Expensed as incurred.

M88#6. 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#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></th>
<th>Productive output</th>
<th>Sum of the years' digits</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M87#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.

M87#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.

E. Intangibles and Other Assets

M91#11. At the end of its first year of operations [December 31, 1990], Gold Co. reported a current deferred tax asset in accordance with FASB Statement No. 96, Accounting for Income Taxes. Will reversal of current temporary differences result in taxable or deductible amounts, and did Gold have a 1990 profit or loss for tax purposes?

<table>
<thead>
<tr>
<th>Taxable or deductible amounts</th>
<th>Taxable status of 1990 operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Taxable</td>
<td>Profit</td>
</tr>
<tr>
<td>b. Taxable</td>
<td>Loss</td>
</tr>
<tr>
<td>c. Deductible</td>
<td>Profit</td>
</tr>
<tr>
<td>d. Deductible</td>
<td>Loss</td>
</tr>
</tbody>
</table>
Accounting Theory

N90#21. Effective January 1, 1989, Flood Co. established a defined benefit pension plan with no retroactive benefits. The first of the required equal annual contributions was paid on December 31, 1989. A 10% discount rate was used to calculate service cost and a 10% rate of return was assumed for plan assets. All information on covered employees for 1989 and 1990 is the same. How should the service cost for 1990 compare with 1989, and should the 1989 balance sheet report an accrued or a prepaid pension cost?

<table>
<thead>
<tr>
<th>Service cost for 1990 compared to 1989</th>
<th>Pension cost reported on the 1989 balance sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Equal to</td>
<td>Accrued</td>
</tr>
<tr>
<td>b. Equal to</td>
<td>Prepaid</td>
</tr>
<tr>
<td>c. Greater than</td>
<td>Accrued</td>
</tr>
<tr>
<td>d. Greater than</td>
<td>Prepaid</td>
</tr>
</tbody>
</table>

N90#6. The premium on a three-year insurance policy expiring on December 31, 1991 was paid in total on January 2, 1989. If the company has a six-month operating cycle, then on December 31, 1989, the prepaid insurance reported as a current asset would be for

a. 6 months.
b. 12 months.
c. 18 months.
d. 24 months.

N89#11. Which of the following costs associated with an internally developed patent should be capitalized?

<table>
<thead>
<tr>
<th>Research and development</th>
<th>Patent registration</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>

N89#12. On December 31, 1987, the New Bite Company had capitalized costs for a new computer software product with an economic life of four years. Sales for 1988 were ten percent of expected total sales of the software. At December 31, 1988, the software had a net realizable value equal to eighty percent of the capitalized cost. The unamortized cost reported on the December 31, 1988, balance sheet should be

a. Net realizable value.
b. Ninety percent of net realizable value.
c. Seventy-five percent of capitalized cost.
d. Ninety percent of capitalized cost.

N88#9. Which of the following legal fees should be capitalized?

<table>
<thead>
<tr>
<th>Legal fees to obtain a franchise</th>
<th>Legal fees to successfully defend a trademark</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#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>

N87#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 it 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.
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

M91#13. On May 1, 1990, Marno County issued property tax assessments for the fiscal year ended June 30, 1991. The first of two equal installments was due on November 1, 1990. On September 1, 1990, Dyur Co. purchased a 4-year old factory in Marno subject to an allowance for accrued taxes. Dyur did not record the entire year’s property tax obligation, but instead records taxes expenses at the end of each month by adjusting prepaid property taxes or property taxes payable, as appropriate. The recording of the November 1, 1990, payment by Dyur should have been allocated between an increase in prepaid property taxes and a decrease in property taxes payable in which of the following percentages?

<table>
<thead>
<tr>
<th>Percentage allocated to</th>
<th>Increase in prepaid property taxes</th>
<th>Decrease in property taxes payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>66⅔%</td>
<td>33⅓%</td>
</tr>
<tr>
<td>b.</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>c.</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>d.</td>
<td>33⅓%</td>
<td>66⅔%</td>
</tr>
</tbody>
</table>

M91#14. At the end of 1989, Ritzcar Co. failed to accrue sales commissions earned during 1989 but paid in 1990. The error was not repeated in 1990. What was the effect of this error on 1989 ending working capital and on the 1990 ending retained earnings balance?

<table>
<thead>
<tr>
<th>1989 ending working capital</th>
<th>1990 ending retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Overstated</td>
<td>Overstated</td>
</tr>
<tr>
<td>b. No effect</td>
<td>Overstated</td>
</tr>
<tr>
<td>c. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Overstated</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M90#22. Which of the following is generally associated with payables classified as accounts payable?

<table>
<thead>
<tr>
<th>Periodic payment of interest</th>
<th>Secured by collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M90#7. On December 31, 1989, special insurance costs, incurred but unpaid, were not recorded. If these insurance costs were related to work-in-process, what is the effect of the omission on accrued liabilities and retained earnings in the December 31, 1989 balance sheet?

<table>
<thead>
<tr>
<th>Accrued liabilities</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>Overstated</td>
</tr>
<tr>
<td>c. Understated</td>
<td>No effect</td>
</tr>
<tr>
<td>d. Understated</td>
<td>Overstated</td>
</tr>
</tbody>
</table>

M90#8. A company issued a short-term note payable with a stated 12% rate of interest to a bank. The bank charged a .5% loan origination fee and remitted the balance to the company. The effective interest rate paid by the company in this transaction would be

a. Equal to 12.5%.
b. More than 12.5%.
c. Less than 12.5%.
d. Independent of 12.5%.

N89#13. A company receives an advance payment for special order goods that are to be manufactured and delivered within six months. The advance payment should be reported in the company’s balance sheet as a

a. Deferred charge.
b. Contra asset account.
c. Current liability.
d. Noncurrent liability.

N88#10. At the end of the accounting period, which of the following costs should be accrued?

<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>
**Accounting Theory**

**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>At December 31, 1986</th>
<th>At December 31, 1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. (4) months</td>
<td>16 months</td>
</tr>
<tr>
<td>b. (4) months</td>
<td>4 months</td>
</tr>
<tr>
<td>c. (12) months</td>
<td>24 months</td>
</tr>
<tr>
<td>d. (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>

**B. Deferred Revenues**

**M91#15.** An automobile dealer sells service contracts. The contracts stipulate that the dealer will perform specific repairs on covered vehicles. The contracts vary in length from 12 to 36 months. Do the following increase when service contracts are sold?

<table>
<thead>
<tr>
<th>Deferred revenue</th>
<th>Service revenue</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. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**N90#23.** Jersey, Inc. is a retailer of home appliances and offers a service contract on each appliance sold. Jersey sells appliances on installment contracts, but all service contracts must be paid in full at the time of sale. Collections received for service contracts should be recorded as an increase in:

a. Deferred revenue account.
b. Sales contracts receivable valuation account.

c. Stockholders' valuation account.
d. Service revenue account.

**N90#24.** Able sold its headquarters building at a gain, and simultaneously leased back the building. The lease was reported as a capital lease. At the time of sale, the gain should be reported as:

a. Operating income.
b. An extraordinary item, net of income tax.
c. A separate component of stockholders' equity.
d. An asset valuation allowance.

**N90#9.** A retail store received cash and issued gift certificates that are redeemable in merchandise. The gift certificates lapse one year after they are issued. How would the deferred revenue account be affected by each of the following transactions?

<table>
<thead>
<tr>
<th>Redemption of certificates</th>
<th>Lapse of certificates</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>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

**N89#14.** In a sale-leaseback transaction, the seller-lessee has retained the property. The gain on the sale should be recognized at the time of the sale-leaseback when the lease is classified as:

<table>
<thead>
<tr>
<th>Capital lease</th>
<th>Operating lease</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**N88#11.** According to the installment method of accounting, the gross profit on an installment sale is recognized in income:

a. On the date of sale.
b. On the date the final cash collection is received.
c. After cash collections equal to the cost of sales have been received.
d. In proportion to the cash collections received.

**M88#12.** A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a

a. Deferred revenue account should be decreased.
b. Deferred revenue account should be increased.
c. Revenue account should be decreased.
d. Revenue account should be increased.

**N87#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
Selected Questions

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>

C. Deferred Income Tax Liabilities

M91#12. On December 31, 1990, Oak Co. recognized a receivable for taxes paid in prior years and refundable through the carryback of all of its 1990 operating loss. Also, Oak had a 1990 deferred tax liability derived from the temporary difference between tax and financial statement depreciation, which reverses over the period 1991–1995. The amount of this tax liability is less than the amount of the tax asset. Which of the following 1990 balance sheet sections should report tax-related items in accordance with FASB Statement No. 96, Accounting for Income Taxes?

I. Current assets.
II. Current liabilities.
III. Noncurrent liabilities.
   a. I only.
   b. I and II.
   c. I, II, and III.
   d. II and III.

N90#27. Senlo Co., which uses a one-year operating cycle, recognized profits for both financial statement and tax purposes during its two years of operation. Depreciation for tax purposes exceeded depreciation for financial statement purposes in each year. These temporary differences are expected to reverse in years 3, 4, and 5. According to FASB 96, at the end of year 2 the deferred tax liability shown as a current liability is based on the
   a. Enacted tax rates for years 3, 4, and 5.
   b. Enacted tax rate for year 3.
   c. Tax rates for years 1 and 2.
   d. Tax rate for year 2.

M90#10. Cahn Co. applies straight-line amortization to its organization costs for both income taxes and financial statement reporting. However, for tax purposes a 5-year period is used and for financial statement purposes a 10-year period is used. Cahn has no other temporary differences, has an operating cycle of less than 1 year, and has taxable income in all years. Cahn should report both current and noncurrent deferred income tax liabilities at the end of

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 8</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N90#15. As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of a company's plant assets exceeded the tax basis. Assuming the company had no other temporary differences, the company should report a
   b. Current tax payable.
   c. Deferred tax asset.
   d. Deferred tax liability.

D. Capitalized Lease Liability

N90#25. Lease A 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 B 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 A</th>
<th>Lease B</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Operating lease</td>
<td>Capital lease</td>
</tr>
<tr>
<td>b. Operating lease</td>
<td>Operating 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>

M90#11. A lessee had a ten-year capital lease requiring equal annual payments. The reduction of the lease liability in year 2 should equal
   a. The current liability shown for the lease at the end of year 1.
   b. The current liability shown for the lease at the end of year 2.
   c. The reduction of the lease obligation in year 1.
   d. One-tenth of the original lease liability.

N90#16. The present value of minimum lease payments should be used by the lessee in determining the amount of a lease liability under a lease classified by the lessee as a(an)

<table>
<thead>
<tr>
<th>Capital lease</th>
<th>Operating lease</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>

N88#13. A six-year capital lease expiring on December 31 specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fifth year applicable to the reduction of the net lease liability should be
   a. Less than in the fourth year.
   b. More than in the fourth year.
   c. The same as in the sixth year.
   d. More than in the sixth year.
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.

E. Bonds Payable

M91#5. A 15-year bond was issued in 1980 at a discount. During 1990, a 10-year bond was issued at face amount with the proceeds used to retire the 15-year bond at its face amount. The net effect of the 1990 bond transactions was to increase long-term liabilities by the excess of the 10-year bond's face amount over the 15-year bond's  
   a. Face amount.  
   b. Carrying amount.  
   c. Face amount less the deferred loss on bond retirement.  
   d. Carrying amount less the deferred loss on bond retirement.

M91#6. On March 1, 1990, Clark Co. issued bonds at a discount. Clark incorrectly used the straight-line method instead of the effective interest method to amortize the discount. How were the following amounts, as of December 31, 1990, affected by the error?  

<table>
<thead>
<tr>
<th>Bond carrying amount</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Overstated</td>
<td>Overstated</td>
</tr>
<tr>
<td>b. Understated</td>
<td>Understated</td>
</tr>
<tr>
<td>c. Overstated</td>
<td>Understated</td>
</tr>
<tr>
<td>d. Understated</td>
<td>Overstated</td>
</tr>
</tbody>
</table>

N90 Items 29 and 30 are based on the following:  

On January 2, 1986, Chard Co. issued 10-year convertible bonds at 105. During 1989, these bonds were converted into common stock having an aggregate par value equal to the total face amount of the bonds. At conversion, the market price of Chard's common stock was 50 percent above its par value.

29. On January 2, 1986, cash proceeds from the issuance of the convertible bonds should be reported as  
   a. Contributed capital for the entire proceeds.  
   b. Contributed capital for the portion of the proceeds attributable to the conversion feature and as a liability for the balance.  
   c. A liability for the face amount of the bonds and contributed capital for the premium over the face amount.  
   d. A liability for the entire proceeds.

30. Depending on whether the book value method or the market value method was used, Chard would recognize gains or losses on conversion when using the

<table>
<thead>
<tr>
<th>Book value method</th>
<th>Market value method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Either gain or loss</td>
<td>Gain</td>
</tr>
<tr>
<td>b. Either gain or loss</td>
<td>Loss</td>
</tr>
<tr>
<td>c. Neither gain nor loss</td>
<td>Loss</td>
</tr>
<tr>
<td>d. Neither gain nor loss</td>
<td>Gain</td>
</tr>
</tbody>
</table>

N90#31. Main Co. issued bonds with detachable common stock warrants. Only the warrants had a known market value. The sum of the fair value of the warrants and the face amount of the bonds exceeds the cash proceeds. This excess is reported as  
   a. Discount on bonds payable.  
   b. Premium on bonds payable.  
   c. Common stock subscribed.  
   d. Contributed capital in excess of par-stock warrants.

N89#17. How would the carrying amount of a bond payable be affected by amortization of the following?

<table>
<thead>
<tr>
<th>Discount</th>
<th>Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

N89#18. Bonds payable issued with scheduled maturities at various dates are called

<table>
<thead>
<tr>
<th>Serial bonds</th>
<th>Term bonds</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>

N89#19. When bonds payable are converted into common stock, any gain or loss 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>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>

T-12
Selected Questions

**M88#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>

**M88#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.

**M88#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.

**M89#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#17.** A five-year term bond was issued by a company on January 1, 1985, at a premium. The carrying amount of the bond at December 31, 1986, would be

a. The same as the carrying amount at January 1, 1985.
c. Lower than the carrying amount at December 31, 1987.
d. Lower than the carrying amount at December 31, 1985.

**M87#18.** The proceeds from a bond issued with detachable stock purchase warrants should be accounted for

a. Entirely as bonds payable.
b. Entirely as stockholders' equity.
c. Partially as unearned revenue, and partially as bonds payable.
d. Partially as stockholders' equity, and partially as bonds payable.

F. Contingent Liabilities and Commitments

**M91#16.** A manufacturer of household appliances may incur a loss due to the discovery of a defect in one of its products. The occurrence of the loss is reasonably possible and the resulting costs can be reasonably estimated. This possible loss should be

<table>
<thead>
<tr>
<th>Accrued</th>
<th>Disclosed in footnotes</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>

**M90#35.** Wyatt Co. has a probable loss that can only be reasonably estimated within a range of outcomes. No single amount within the range is a better estimate than any other amount. The loss accrual should be

a. Zero.
b. The maximum of the range.
c. The mean of the range.
d. The minimum of the range.
Management can estimate the amount of the loss that will occur if a foreign government expropriates some company assets. If expropriation is reasonably possible, a loss contingency should be a. Neither accrued as a liability nor disclosed. b. Accrued as a liability but not disclosed. c. Disclosed and accrued as a liability. d. Disclosed but not accrued as a liability.

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

\[
\begin{array}{cc|cc}
\text{Accrued} & \text{Disclosed} \\
\text{in footnotes} & & \\
\hline
a. & No & Yes \\
b. & No & No \\
c. & Yes & No \\
d. & Yes & Yes \\
\end{array}
\]

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

\[
\begin{array}{cc|cc}
\text{Accrued} & \text{Disclosed} \\
b. & Yes & No \\
c. & No & Yes \\
d. & No & No \\
\end{array}
\]

### IV. Ownership Structure, Presentation, and Valuation of Equity Accounts

#### A. Preferred and Common Stock

The acquisition of treasury stock will cause the number of shares outstanding to decrease if the treasury stock is accounted for by the

\[
\begin{array}{cc|cc}
\text{Cost method} & \text{Par value method} \\
\hline
a. Yes & No \\
b. No & No \\
c. Yes & Yes \\
d. No & Yes \\
\end{array}
\]

The number of common stock shares outstanding would be decreased by the

\[
\begin{array}{cc|cc}
\text{Declaration of a stock dividend} & \text{Purchase of treasury stock} \\
\hline
a. No & No \\
b. No & Yes \\
c. Yes & Yes \\
d. Yes & Yes \\
\end{array}
\]

On December 1, 1987, shares of authorized common stock were issued on a subscription basis at a price in excess of par value. A total of 20% of the subscription price of each share was collected as a down payment on December 1, 1987, with the remaining 80% of the subscription price of each share due in 1988. Collectibility was reasonably assured. At December 31, 1987, the stockholders' equity section of the balance sheet would report additional paid-in capital for the excess of the subscription price over the par value of the shares of common stock subscribed and

\[
\begin{array}{cc|cc}
\text{February 1, 1988} & \text{March 1, 1988} \\
a. Yes & No \\
b. Yes & Yes \\
c. No & No \\
d. No & Yes \\
\end{array}
\]

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.

C. Retained Earnings and Dividends

M91#17. A company declared a cash dividend on its common stock on December 15, 1990, payable on January 12, 1991. How would this dividend affect stockholders’ equity on the following dates?

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N90#32. How would the declaration of a 15% stock dividend by a corporation affect each of the following?

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Total stockholders’ equity</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>

N90#36. Which of the following should be reported as a prior period adjustment?

<table>
<thead>
<tr>
<th>Change in estimated lives of depreciable assets</th>
<th>Change from unaccepted principle to accepted principle</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. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M90#14. Pott Co. owned shares in Rose Co. On December 1, 1989, Pott declared and distributed a property dividend of Rose shares when their fair value exceeded the carrying amount. As a consequence of the dividend declaration and distribution, the accounting effects would be

<table>
<thead>
<tr>
<th>Property dividends recorded at</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Fair value</td>
<td>Decreased</td>
</tr>
<tr>
<td>b. Fair value</td>
<td>Increased</td>
</tr>
<tr>
<td>c. Cost</td>
<td>Increased</td>
</tr>
<tr>
<td>d. Cost</td>
<td>Decreased</td>
</tr>
</tbody>
</table>

N68#21. A corporation declared a dividend, a portion of which was liquidating. How would this declaration affect each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>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>

N68#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>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N68#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>Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>Decrease</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M89#22. Ten thousand shares of $10 par value common stock were issued initially at $15 per share. Subsequently, one thousand of these shares were purchased as treasury stock at $13 per share. The cost method of accounting for treasury stock is used. What is the effect of the purchase of the treasury stock on the amount reported in the balance sheet on each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Total stockholders' equity</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>

D. Treasury Stock and Other Contra Accounts

M91#18. On incorporation, Dee Inc. issued common stock at a price in excess of its par value. No other stock transactions occurred except treasury stock was acquired for an amount exceeding this issue price. If Dee uses the par value method of accounting for treasury stock appropriate for retired stock, what is the effect of the acquisition on the following?

<table>
<thead>
<tr>
<th>Net common stock</th>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

N90#33. At its date of incorporation, Glean, Inc. issued 100,000 shares of its $10 par common stock at $11 per share. During the current year, Glean acquired 30,000 shares of its common stock at a price of $16 per share and accounted for them by the cost method. Subsequently, these shares were reissued at a price of $12 per share. There have been no other issuances or acquisitions of its own common stock. What effect does the reissuance of the stock have on the following accounts?

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Additional paid-in capital</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. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M90#15. Treasury stock was acquired for cash at a price in excess of its original issue price. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect on total stockholders' equity of each of the following events?

<table>
<thead>
<tr>
<th>Acquisition of treasury stock</th>
<th>Reissuance of treasury stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. No effect</td>
<td>No effect</td>
</tr>
</tbody>
</table>

N88#19. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the subsequent reissuance of the treasury stock on each of the following?

<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>

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?
Selected Questions

<table>
<thead>
<tr>
<th>Acquisition of treasury stock</th>
<th>Reissue of treasury stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Increase</td>
</tr>
<tr>
<td>b. No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>c. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M87#33. Five thousand (5,000) shares of common stock with a par value of $10 per share were issued initially at $12 per share. Subsequently, one thousand (1,000) of these shares were acquired as treasury stock at $15 per share. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect of the acquisition of the treasury stock on each of the following?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

E. Stock Options, Warrants, and Rights

M91#19. Cricket Corp. issued, without consideration, rights allowing stockholders to subscribe for additional shares at an amount greater than par value but less than both market and book values. When the rights are exercised, how are the following accounts affected?

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decreased</td>
<td>Not affected</td>
</tr>
<tr>
<td>b. Not affected</td>
<td>Not affected</td>
</tr>
<tr>
<td>c. Decreased</td>
<td>Increased</td>
</tr>
<tr>
<td>d. Not affected</td>
<td>Increased</td>
</tr>
</tbody>
</table>

M90#16. Blue Co. issued preferred stock with detachable common stock warrants at a price which exceeded both the par value and the market value of the preferred stock. At the time the warrants are exercised, Blue’s total stockholders’ equity is increased by the

<table>
<thead>
<tr>
<th>Cash received upon exercise of the warrants</th>
<th>Carrying amount of warrants</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>

M89#11. A company issued rights to its existing shareholders without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. When the rights are issued, which of the following will be increased?

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Additional paid-in capital</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>

N88#20. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Common stock will be increased when the

<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>

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. Debit when the rights are exercised.    |
| d. Debit 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>

N89#23. A corporation issued rights to its existing shareholders to purchase unissued shares of $10 par value common stock for $25 per share. The rights were issued for no consideration. Additional paid-in capital will be credited when the rights are
Accounting Theory

G. Partnerships

M91#39. Four individuals who were previously sole proprietors form a partnership. Each partner contributes inventory and equipment for use by the partnership. What basis should the partnership use to record the contributed assets?
   a. Inventory at the lower of FIFO cost or market.
   b. Inventory at the lower of weighted average cost or market.
   c. Equipment at each proprietor’s carrying amount.
   d. Equipment at fair value.

N90#40. Hayes and Jenkins formed a partnership, each contributing assets to the business. Hayes contributed inventory with a current market value in excess of its carrying amount. Jenkins contributed real estate with a carrying amount in excess of its current market value. At what amount should the partnership record each of the following assets?

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Real estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Market value</td>
<td>Market value</td>
</tr>
<tr>
<td>b. Market value</td>
<td>Carrying amount</td>
</tr>
<tr>
<td>c. Carrying amount</td>
<td>Market value</td>
</tr>
<tr>
<td>d. Carrying amount</td>
<td>Carrying amount</td>
</tr>
</tbody>
</table>

M90#17. Allen retired from the partnership of Allen, Beck and Chale. Allen’s cash settlement from the partnership was based on new goodwill determined at the date of retirement plus the carrying amount of the other net assets. As a consequence of the settlement, the capital accounts of Beck and Chale were decreased. In accounting for Allen’s withdrawal, the partnership could have used the

<table>
<thead>
<tr>
<th>Bonus method</th>
<th>Goodwill method</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M89#24. On July 1, 1988, a partnership was formed by Johnson and Smith. Johnson contributed cash. Smith, previously a sole proprietor, contributed property other than cash including realty subject to a mortgage, which was assumed by the partnership. Smith’s capital account at July 1, 1988, should be recorded at
   b. Smith’s book value of the property less the mortgage payable at July 1, 1988.
   c. The fair value of the property less the mortgage payable at July 1, 1988.
   d. The fair value of the property at July 1, 1988.

M89#12. The Low and Rhu partnership agreement provides special compensation to Low for managing the business. Low receives a bonus of 15 percent of partnership net income before salary and bonus, and also receives a salary of $45,000. Any remaining profit or loss is to be allocated equally. During 1988, the partnership had net income of $50,000 before the bonus and salary allowance. As a result of these distributions, Rhu’s equity in the partnership would
   a. Increase.
   b. Not change.
   c. Decrease the same as Low’s.
   d. Decrease.

N88#21. The partnership of Metcalf, Petersen, and Russell shared profits and losses equally. When Metcalf withdrew from the partnership, the partners agreed that there was unrecorded goodwill in the partnership. Under the bonus method, the capital balances of Petersen and Russell were
   a. Not affected.
   b. Each reduced by one half of the total amount of the unrecorded goodwill.
   c. Each reduced by one third of the total amount of the unrecorded goodwill.
   d. Each reduced by one half of Metcalf’s share of the total amount of the unrecorded goodwill.

M88#22. A partnership is formed by two individuals who were previously sole proprietors. Which of the following parts of the initial investment in the newly created partnership would be recorded at the fair value at the date of the investment?

<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.
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

M91#8. Drew Co. produces expensive equipment for sale on installment contracts. When there is doubt about eventual collectibility, the income recognition method least likely to overstate income is
a. At the time the equipment is completed.
b. The installment method.
c. The cost recovery method.
d. At the time of delivery.

M91#9. Bee Co. uses the direct write-off method to account for uncollectible accounts receivable. During an accounting period, Bee's cash collections from customers equal sales adjusted for the addition or deduction of the following amounts:

<table>
<thead>
<tr>
<th>Accounts written-off</th>
<th>Increase in accounts receivable balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction</td>
<td>Deduction</td>
</tr>
<tr>
<td>Addition</td>
<td>Addition</td>
</tr>
<tr>
<td>Deduction</td>
<td>Addition</td>
</tr>
<tr>
<td>Addition</td>
<td>Addition</td>
</tr>
</tbody>
</table>

M91#20. Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun Inc.'s common stock. On January 1, 1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

<table>
<thead>
<tr>
<th>Inventory excess</th>
<th>Land excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>Decrease</td>
<td>No effect</td>
</tr>
<tr>
<td>Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>Increase</td>
<td>No effect</td>
</tr>
</tbody>
</table>

M91#22. For a marketable equity securities portfolio included in noncurrent assets, which of the following amounts should be included in the period's net income?

I. Unrealized temporary losses during the period.
II. Realized gains during the period.
III. Changes in the valuation allowance during the period.
   a. III only.
   b. II only.
   c. I and II.
   d. I, II, and III.

M91#28. Tay Co. uses the percentage-of-completion method to account for a five-year construction contract.

Third year progress billings collected in the fourth year would
a. Be included in the calculation of third year income.
b. Be included in the calculation of third year income in so far as they exceeded second year billings collected in the third year.
c. Be included in the calculation of fourth year income.
d. Not be included in the calculation of third, fourth, or fifth year incomes.

M90#26. In a lease that is recorded as a sales-type lease by the lessor, interest revenue
a. Should be recognized in full as revenue at the lease's inception.
b. Should be recognized over the period of the lease using the straight-line method.
c. Should be recognized over the period of the lease using the effective interest method.
d. Does not arise.

M90#37. Gown, Inc. sold a warehouse and used the proceeds to acquire a new warehouse. The excess of the proceeds over the carrying amount of the warehouse sold should be reported as a(an)
   a. Extraordinary gain, net of income taxes.
   b. Part of continuing operations.
   c. Gain from discontinued operations, net of income taxes.
   d. Reduction of the cost of the new warehouse.

M90#39. Gains from remeasuring a foreign subsidiary's financial statements from the local currency, which is not the functional currency, into the parent company's currency should be reported as a(an)
   a. Deferred foreign exchange gain.
   b. Separate component of stockholders' equity.
   c. Extraordinary item, net of income taxes.
   d. Part of continuing operations.

M90#18. Compared to the accrual basis of accounting, the cash basis of accounting overstates income by the net increase during the accounting period of the

<table>
<thead>
<tr>
<th>Accounts receivable</th>
<th>Accrued expenses payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Accounting Theory

**M90#19.** A company used the percentage-of-completion method of accounting for a four-year construction contract. Which of the following items would be used to calculate 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. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</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>

c. On the date the final cash collection is received.

d. On the date of sale.

**M90#15.** An investor uses the equity method to account for an investment in common stock. The investor's equity in the earnings of the investee would be affected by

<table>
<thead>
<tr>
<th>Cash dividends from investee</th>
<th>A change in market value of the investee’s common stock</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>

**M90#16.** Under a royalty agreement with another enterprise, a company will receive royalties from the assignment of a patent for four years. The royalties received in advance should be reported as revenue

a. In the period received.
b. In the period earned.
c. Evenly over the life of the royalty agreement.
d. At the date of the royalty agreement.

**N89#13.** A company uses the completed-contract method to account for a four-year construction contract which is presently in its third year. Progress billings were recorded and collected in the third year. Based on events occurring in the third year, there is now an anticipated loss on the contract. When would the effect of each of the following be reported in the company’s income statement?

<table>
<thead>
<tr>
<th>Third year progress billings</th>
<th>Anticipated loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Not third year</td>
<td>Third year</td>
</tr>
<tr>
<td>b. Not third year</td>
<td>Fourth year</td>
</tr>
<tr>
<td>c. Third year</td>
<td>Third year</td>
</tr>
<tr>
<td>d. Third year</td>
<td>Fourth year</td>
</tr>
</tbody>
</table>

**N89#15.** An investor uses the equity method to account for an investment in common stock. The investor’s equity in the earnings of the investee would be affected by

<table>
<thead>
<tr>
<th>Cash dividends from investee</th>
<th>A change in market value of the investee’s common stock</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#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?

<table>
<thead>
<tr>
<th>Actual total costs</th>
<th>Income previously recognized</th>
<th>Progress billings</th>
<th>Collections on progress billings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**M88#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>

**M88#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
Selected Questions

changes resulted in gains. The amount of the gain that should be included in the 1988 financial statements would be
   d. Zero.

M88#23. A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when progress billings are

<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>

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>

M87#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.</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M87#26. A company uses the percentage-of-completion method to account for a four-year construction contract. Progress billings sent in the second year that were collected in the third year would
   a. Not be included in the calculation of the income recognized in the second, third, or fourth year.
   b. Be included in the calculation of the income recognized in the second year.
   c. Be included in the calculation of the income recognized in the third year.
   d. Be included in the calculation of the income recognized in the fourth year.

M87#27. A lease is recorded as a sales-type lease by the lessor. The difference between the gross investment in the lease and the sum of the present values of the two components of the gross investment (the net receivable) should be
   a. Amortized over the period of the lease as interest revenue using the interest method.
   b. Amortized over the period of the lease as interest revenue using the straight-line method.
   c. Recognized in full as interest revenue at the lease's inception.
   d. Recognized in full as manufacturer’s or dealer’s profit at the lease’s inception.

B. Expenses and Losses

M91#23. During 1990, Bay Co. constructed machinery for its own use and for sale to customers. Bank loans financed these assets both during construction and after construction was complete. How much of the interest incurred should be reported as interest expense in the 1990 income statement?

<table>
<thead>
<tr>
<th>Interest incurred for machinery for own use</th>
<th>Interest incurred for machinery held for sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. All interest incurred</td>
<td>All interest incurred</td>
</tr>
<tr>
<td>b. All interest incurred</td>
<td>Interest incurred after completion</td>
</tr>
<tr>
<td>c. Interest incurred after completion</td>
<td>Interest incurred after completion</td>
</tr>
<tr>
<td>d. Interest incurred after completion</td>
<td>All interest incurred</td>
</tr>
</tbody>
</table>

M91#25. A transaction that is unusual, but not infrequent, should be reported separately as a(an)
   a. Extraordinary item, net of applicable income taxes.
   b. Extraordinary item, but not net of applicable income taxes.
   c. Component of income from continuing operations, net of applicable income taxes.
   d. Component of income from continuing operations, but not net of applicable income taxes.
Accounting Theory

**M90#14.** The graph below depicts three depreciation expense patterns over time.

![Graph showing three depreciation expense patterns](image)

Which depreciation expense pattern corresponds to the sum-of-the-years'-digits method and which corresponds to the double-declining-balance method?

<table>
<thead>
<tr>
<th>Sum-of-the-years'-digits</th>
<th>Double-declining balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. III</td>
<td>II</td>
</tr>
<tr>
<td>b. II</td>
<td>I</td>
</tr>
<tr>
<td>c. I</td>
<td>III</td>
</tr>
<tr>
<td>d. II</td>
<td>III</td>
</tr>
</tbody>
</table>

**M90#19.** Under the allowance method of recognizing uncollectible accounts, the entry to write-off an uncollectible account

a. Increases the allowance for uncollectible accounts.
b. Has no effect on the allowance for uncollectible accounts.
c. Has no effect on net income.
d. Decreases net income.

**M90#21.** Net income is understated if, in the first year, estimated salvage value is excluded from the depreciation computation when using the

<table>
<thead>
<tr>
<th>Straight-line method</th>
<th>Production or use method</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**M90#23.** Interest cost included in the net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan represents the

a. Shortage between the expected and actual returns on plan assets.
b. Increase in the projected benefit obligation due to the passage of time.
c. Increase in the fair value of plan assets due to the passage of time.
d. Amortization of the discount on unrecognized prior service costs.

**M90#24.** A twenty-year property lease, classified as an operating lease, provides for a 10% increase in annual payments every five years. In the sixth year compared to the fifth year, the lease will cause the following expenses to increase

<table>
<thead>
<tr>
<th>Rent</th>
<th>Interest</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>

**M89#26.** A bond issued on June 1, 1988, has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 1988, would be for a period of

a. Three months.
b. Four months.
c. Six months.
d. Seven months.

**M89#17.** A machine with a four-year estimated useful life and an estimated 10% salvage value was acquired on January 1, 1986. The depreciation expense for 1988 using the double-declining-balance method would be original cost multiplied by

a. $90\% \times 50\% \times 50\% \times 50\%$.
b. $50\% \times 50\% \times 50\%$.
c. $90\% \times 50\% \times 50\%$.
d. $50\% \times 50\%$.

**M89#18.** A sale of goods was denominated in a currency other than the entity's functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. The exchange rate between the functional currency and the currency in which the transaction was denominated changed. The effect of the change should be included as a

a. Separate component of stockholders' equity whether the change results in a gain or a loss.
b. Separate component of stockholders' equity if the change results in a gain, and as a component of income if the change results in a loss.
c. Component of income if the change results in a gain, and as a separate component of stockholders' equity if the change results in a loss.
d. Component of income whether the change results in a gain or a loss.
Selected Questions

M89#19. A company uses the allowance method to recognize uncollectible accounts expense. What is the effect at the time of the collection of an account previously written off on each of the following accounts?

<table>
<thead>
<tr>
<th>Allowance for uncollectible accounts</th>
<th>Uncollectible accounts expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</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>

M89#20. Which of the following components should be included in net pension cost by an employer sponsoring a defined benefit pension plan?

<table>
<thead>
<tr>
<th>Amortization of unrecognized prior service cost</th>
<th>Fair value of 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>

M89#21. The effect of a material transaction that is unusual in nature but not infrequent in occurrence should be presented separately as a component of income from continuing operations when the transaction results in a

<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>

M89#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.

M88#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.

M88#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>

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. 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. 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.

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.
N87#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.

C. Provision for Income Tax

N90#28. Nala Inc. reported deferred tax assets and deferred tax liabilities at the end of 1988 and at the end of 1989. According to FASB 96, for the year ended 1989 Nala should report deferred income tax expense or benefit equal to the
   a. Sum of the net changes in deferred tax assets and deferred tax liabilities.
   b. Decrease in the deferred tax assets.
   c. Increase in the deferred tax liabilities.
   d. Amount of the income tax liability plus the sum of the net changes in deferred tax assets and deferred tax liabilities.

M90#25. No deferred tax asset was recognized in the 1988 financial statements by the Chaise Company when a loss from discontinued segments was carried forward for tax purposes. Chaise had no temporary differences. The tax benefit of the loss carried forward reduced current taxes payable on 1989 continuing operations. In accordance with FASB Statement No. 96, the 1989 income statement would include the tax benefit from the loss brought forward in
   a. Income from continuing operations.
   b. Gain or loss from discontinued segments.
   c. Extraordinary gains.
   d. Cumulative effect of accounting changes.

N89#27. Temporary differences arise when expenses are deductible for tax purposes

<table>
<thead>
<tr>
<th>After they are recognized in financial income</th>
<th>Before they are recognized in financial 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>

M89#22. Temporary differences arise when revenues are taxable

<table>
<thead>
<tr>
<th>After they are recognized in financial income</th>
<th>Before they are recognized in financial income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Selected Questions

D. Recurring Versus Nonrecurring Transactions and Events

M91#26. Gains or losses from the early extinguishment of debt, if material, should be
   a. Recognized in income before taxes in the period of extinguishment.
   b. Recognized as an extraordinary item in the period of extinguishment.
   c. Amortized over the life of the new issue.
   d. Amortized over the remaining original life of the extinguished issue.

M90#38. Whetstone Co. took advantage of market conditions to refund debt. This was the fourth refunding operation carried out by Whetstone within the last three years. The excess of the carrying amount of the old debt over the amount paid to extinguish it should be reported as a(an)
   a. Extraordinary gain, net of income taxes.
   b. Extraordinary loss, net of income taxes.
   c. Part of continuing operations.
   d. Deferred credit to be amortized over life of new debt.

M90#26. On September 30, 1989, a commitment was made to dispose of a business segment in early 1990. The segment operating loss for the period October 1 to December 31, 1989, should be included in the 1989 income statement as part of
   a. Loss on disposal of the discontinued segment.
   b. Operating loss of the discontinued segment.
   c. Income or loss from continuing operations.
   d. Extraordinary gains or losses.

M90#33. An extraordinary item should be reported separately on the income statement as a component of income

<table>
<thead>
<tr>
<th></th>
<th>Before discontinued operations of a segment of a business</th>
<th>Net of income taxes</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>

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.

M87#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.

E. Accounting Changes

M91#34. Is the cumulative effect of an inventory pricing change on prior years earnings reported separately between extraordinary items and net income for a change from

<table>
<thead>
<tr>
<th></th>
<th>LIFO to weighted average?</th>
<th>FIFO to weighted average?</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>

M89#24. The cumulative effect of changing to a new accounting principle should be recorded separately as a component of income after continuing operations for a change from the
   a. Straight-line method of depreciation for previously recorded assets to the sum-of-the-years'-digits method.
   b. LIFO method of inventory pricing to the FIFO method.
   c. Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
   d. Cash basis of accounting for vacation pay to the accrual basis.
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>

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.

In determining earnings per share, interest expense, net of applicable income taxes, on convertible debt that is both a common stock equivalent and dilutive should be

a. Added back to net income for primary earnings per share, and ignored for fully diluted earnings per share.

b. Added back to net income for both primary earnings per share and fully diluted earnings per share.

c. Deducted from net income for primary earnings per share, and ignored for fully diluted earnings per share.

d. Deducted from net income for both primary earnings per share and fully diluted earnings per share.

When computing fully diluted earnings per share, convertible securities that are not common stock equivalents are

a. Ignored.

b. Recognized only if they are dilutive.

c. Recognized only if they are anti-dilutive.

d. Recognized whether they are dilutive or anti-dilutive.

An antidilutive common stock option is

<table>
<thead>
<tr>
<th>A common stock equivalent</th>
<th>Included in computing primary 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>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

A company's convertible debt is both a common stock equivalent and dilutive in determining earnings per share. What would be the effect of consideration of the convertible debt in calculating

<table>
<thead>
<tr>
<th>Primary earnings per share</th>
<th>Fully diluted earnings per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>No effect</td>
</tr>
<tr>
<td>c. No effect</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Increase</td>
</tr>
</tbody>
</table>

Antidilutive 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. 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>

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>

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).

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>
Selected Questions

VI. Other Financial Topics

A. Statement of Cash Flows

**M91#30.** In a statement of cash flows, if used equipment is sold at a loss, the amount shown as a cash inflow from investing activities equals the carrying amount of the equipment:

- a. Less the loss and plus the amount of tax attributable to the loss.
- b. Less both the loss and the amount of tax attributable to the loss.
- c. Less the loss.
- d. With no addition or subtraction.

**M91#31.** In a statement of cash flows, which of the following items is reported as a cash outflow from financing activities?

- I. Payments to retire mortgage notes.
- II. Interest payments on mortgage notes.
- III. Dividend payments.
  - a. I, II, and III.
  - b. II and III.
  - c. I only.
  - d. I and III.

**M90** Items 27 and 28 are based on the following:

A company acquired a building, paying a portion of the purchase price in cash and issuing a mortgage note payable to the seller for the balance.

27. In a statement of cash flows, what amount is included in investing activities for the above transaction?

- a. Cash payment.
- b. Acquisition price.
- d. Mortgage amount.

28. In a statement of cash flows, what amount is included in financing activities for the above transaction?

- a. Cash payment.
- b. Acquisition price.
- d. Mortgage amount.

**M89#29.** In a statement of cash flows, proceeds from issuing equity instruments should be classified as cash inflows from

- a. Lending activities.
- b. Operating activities.
- c. Investing activities.
- d. Financing activities.

**M89#30.** In a statement of cash flows, payments to acquire debt instruments of other entities (other than cash equivalents) should be classified as cash outflows for

- a. Operating activities.
- b. Investing activities.
- c. Financing activities.
- d. Lending activities.

**M89#26.** In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should generally be classified as cash inflows from

- a. Operating activities.
- b. Financing activities.
- c. Investing activities.
- d. Selling activities.

**M89#27.** In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for

- a. Operating activities.
- b. Borrowing activities.
- c. Lending activities.
- d. Financing activities.

B. Accounting Policies

**M91#32.** The summary of significant accounting policies should disclose the:

- a. Pro forma effect of retroactive application of an accounting change.
- b. Basis of profit recognition on long-term construction contracts.
- c. Adequacy of pension plan assets in relation to vested benefits.
- d. Future minimum lease payments in the aggregate and for each of the five succeeding fiscal years.

**M90#30.** Which of the following facts concerning fixed assets should be included in the summary of significant accounting policies?

<table>
<thead>
<tr>
<th>Depreciation method</th>
<th>Composition</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>

**M89#28.** Which of the following should be disclosed in the summary of significant accounting policies?

<table>
<thead>
<tr>
<th>Composition of inventories</th>
<th>Maturity dates of long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>
Accounting Theory

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>

N87#25. Which of the following should be disclosed in the summary of significant accounting policies?

<table>
<thead>
<tr>
<th>Composition of inventories</th>
<th>Depreciation expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

C. Accounting Changes

M91#27. When a company changes the expected service life of an asset because additional information has been obtained, which of the following should be reported?

<table>
<thead>
<tr>
<th>Pro forma effects of retroactive application</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. No</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>

M89#29. A change in the periods benefitted by a deferred cost because additional information has been obtained is

b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
c. An accounting change that should be reported in the period of change and future periods if the change affects both.
d. Not an accounting change.

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.

D. Nonmonetary Transactions

M91#35. May Co. and Sty Co. exchanged nonmonetary assets. The exchange did not culminate an earning process for either May or Sty. May paid cash to Sty in connection with the exchange. To the extent that the amount of cash exceeds a proportionate share of the carrying amount of the asset surrendered, a realized gain on the exchange should be recognized by

<table>
<thead>
<tr>
<th>May</th>
<th>Sty</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>

N90#12. Solen Co. and Nolse Co. exchanged similar trucks with fair values in excess of carrying amounts. In addition, Solen paid Noise to compensate for the difference in truck values. As a consequence of the exchange, Solen recognizes

a. A gain equal to the difference between the fair value and carrying amount of the truck given up.
b. A gain determined by the proportion of cash paid to the total consideration.
c. A loss determined by the proportion of cash paid to the total consideration.
d. Neither a gain nor a loss.

M90#31. Scott Co. exchanged similar nonmonetary assets with Dale Co. No cash was exchanged. The carrying amount of the asset surrendered by Scott exceeded both the fair value of the asset received and Dale's carrying amount of that asset. Scott should recognize the difference between the carrying amount of the asset it surrendered and

a. The fair value of the asset it received as a loss.
b. The fair value of the asset it received as a gain.
c. Dale's carrying amount of the asset it received as a loss.
d. Dale's carrying amount of the asset it received as a gain.

N89#34. An investment in marketable securities was accounted for by the cost method. These securities were distributed to stockholders as a property dividend in a nonreciprocal transfer. The dividend should be reported at the

a. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is higher.
b. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is lower.
c. Fair value of the asset transferred.
d. Recorded amount of the asset transferred.
Selected Questions

**N88#36.** An entity disposes of a nonmonetary asset in a nonreciprocal transfer. A gain or loss should be recognized on the disposition of the asset when the fair value of the asset transferred is determinable and the nonreciprocal transfer is to

<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>

**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>

**E. Business Combinations**

**N90#4.** Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

<table>
<thead>
<tr>
<th>Plant and equipment</th>
<th>Long-term debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. K's carrying amount</td>
<td>K's carrying amount</td>
</tr>
<tr>
<td>b. K's carrying amount</td>
<td>Fair value</td>
</tr>
<tr>
<td>c. Fair value</td>
<td>K's carrying amount</td>
</tr>
<tr>
<td>d. Fair value</td>
<td>Fair value</td>
</tr>
</tbody>
</table>

**N90#5.** A business combination is accounted for as a pooling of interests. In the consolidated balance sheet, the following component(s) of stockholders' equity may be less than the sum of those same components of the merging companies

<table>
<thead>
<tr>
<th>Retained earnings</th>
<th>Contributed capital</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>

**N90#32.** In order to report a business combination as a pooling of interests, the minimum amount of an investee's common stock that must be acquired during the combination period in exchange for the investor's common stock is

a. 51 percent.
b. 80 percent.
c. 90 percent.
d. 100 percent.

**M90#33.** In a business combination accounted for as a purchase, the appraisal value of the identifiable assets acquired exceeds the acquisition price. The excess appraisal value should be reported as a

a. Deferred credit.
b. Reduction of the values assigned to current assets and a deferred credit for any unallocated portion.
c. Reduction of the values assigned to noncurrent assets and a deferred credit for any unallocated portion.
d. Pro rata reduction of the values assigned to current and noncurrent assets.

**N89#32.** A business combination is accounted for properly as a pooling of interests. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

<table>
<thead>
<tr>
<th>Fees of finders and consultants</th>
<th>Registration fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**N89#33.** A supportive argument for the pooling of interests method of accounting for a business combination is that

a. One company is clearly the dominant and continuing entity.
b. Goodwill is generally a part of any acquisition.
c. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.
d. It was developed within the boundaries of the historical-cost system and is compatible with it.

**M89#30.** A business combination is accounted for appropriately as a pooling of interests. Registration fees related to effecting the business combination should be

a. Deducted directly from retained earnings of the combined corporation.
b. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
c. Capitalized and subsequently amortized over a period not exceeding forty years.
d. Capitalized but not subsequently amortized.
M89#31. A business combination is accounted for appropriately as a purchase. Which of the following should be deducted in determining the combined corporation’s net income for the current period?

<table>
<thead>
<tr>
<th>Direct costs of acquisition</th>
<th>General expenses related to acquisition</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>

M89#35. For interim financial reporting, the computation of a company’s second quarter provision for income taxes uses an effective tax rate expected to be applicable for the full fiscal year. The effective tax rate should reflect anticipated

<table>
<thead>
<tr>
<th>Foreign tax rates</th>
<th>Planning alternatives</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#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

<table>
<thead>
<tr>
<th>Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
</tr>
<tr>
<td>b. Yes</td>
</tr>
<tr>
<td>c. Yes</td>
</tr>
<tr>
<td>d. No</td>
</tr>
</tbody>
</table>

F. Interim Financial Statements

M91#36. A planned volume variance in the first quarter, which is expected to be absorbed by the end of the fiscal period, ordinarily should be deferred at the end of the first quarter if it is

<table>
<thead>
<tr>
<th>Favorable</th>
<th>Unfavorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M90#34. Advertising costs may be accrued or deferred to provide an appropriate expense in each period for

Interim financial reporting

Year-end financial reporting

| a. Yes | No |
| b. Yes | Yes|
| c. Yes | No |
| d. Yes | Yes|

G. Gain Contingencies

M90#35. Grim Corporation operates a plant in a foreign country. It is probable that the plant will be expropriated. However, the foreign government has
indicated that Grim will receive a definite amount of compensation for the plant. The amount of compensation is less than the fair market value but exceeds the carrying amount of the plant. The contingency should be reported
a. As a valuation allowance as a part of stockholders' equity.
b. As a fixed asset valuation allowance account.
c. In the notes to the financial statements.
d. In the income statement.

M89#33. When the occurrence of a gain contingency is reasonably possible and its amount can be reasonably estimated, the gain contingency should be
a. Included in net income and disclosed.
b. Included as an appropriation of retained earnings.
c. Disclosed, but not included in net income.
d. Neither included in net income nor disclosed.

M87#31. When the occurrence of a gain contingency is probable and its amount can be reasonably estimated, the gain contingency should be
a. Recognized in the income statement and disclosed.
b. Classified as an appropriation of retained earnings.
c. Disclosed, but not recognized in the income statement.
d. Neither recognized in the income statement nor disclosed.

H. Segments and Lines of Business

M91#33. In financial reporting of segment data, which of the following would be used to determine a segment's operating income?
 a. Gain or loss on discontinued operations.
 b. General corporate expense.
 c. Sales to other segments.
 d. Income tax expense.

M90#36. YIV Inc. is a multidivisional corporation which has both intersegment sales and sales to unaffiliated customers. YIV should report segment financial information for each division meeting which of the following criteria?
 a. Segment operating profit or loss is 10% or more of consolidated profit or loss.
 b. Segment operating profit or loss is 10% or more of combined operating profit or loss of all company segments.
 c. Segment revenue is 10% or more of combined revenue of all the company segments.
 d. Segment revenue is 10% or more of consolidated revenue.

M89#36. In financial reporting for segments of a business enterprise, the operating profit or loss of a manufacturing segment includes

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Portion of general corporate expense</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>

M88#34. In financial reporting for segments of a business enterprise, which of the following should be taken into account in computing the amount of an industry segment's identifiable assets?

<table>
<thead>
<tr>
<th>Accumulated depreciation</th>
<th>Marketable securities valuation allowance</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#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.

M87#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>

I. Employee Benefits

M91#37. For a defined benefit pension plan, the discount rate used to calculate the projected benefit obligation is determined by the

<table>
<thead>
<tr>
<th>Expected return on plan assets</th>
<th>Actual return on plan assets</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>
Barrett Co. maintains a defined benefit pension plan for its employees. At each balance sheet date, Barrett should report a minimum liability at least equal to the
  a. Accumulated benefit obligation.
  b. Projected benefit obligation.
  c. Unfunded accumulated benefit obligation.
  d. Unfunded projected benefit obligation.

An employer sponsoring a defined benefit pension plan should disclose the

<table>
<thead>
<tr>
<th>Amount of unrecognized prior service cost</th>
<th>Projected benefit obligation</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>

An employer’s obligation relating to employees’ rights to receive compensation for future absences is attributable to employees’ services already rendered. The payment of compensation is probable and the amount of compensation can be reasonably estimated. Employees’ compensation should be
  a. Accrued if the obligation relates to rights that vest or accumulate.
  b. Accrued if the obligation relates to rights that do not vest or accumulate.
  c. Expensed when paid.
  d. Disclosed, but not accrued if the obligation relates to rights that vest or accumulate.

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.

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.

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.

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>

At December 30, 1990, Solomon Co. had a current ratio greater than 1:1 and a quick ratio less than 1:1. On December 31, 1990, all cash was used to reduce accounts payable. How did these cash payments affect the ratios?

<table>
<thead>
<tr>
<th>Current ratio</th>
<th>Quick ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Decreased</td>
<td>Decreased</td>
</tr>
<tr>
<td>b. Decreased</td>
<td>Increased</td>
</tr>
<tr>
<td>c. Increased</td>
<td>Decreased</td>
</tr>
<tr>
<td>d. Increased</td>
<td>Increased</td>
</tr>
</tbody>
</table>

Are the following ratios useful in assessing the liquidity position of a company?

<table>
<thead>
<tr>
<th>Defensive-interval ratio</th>
<th>Return on stockholders’ equity</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>

How is the average inventory used in the calculation of each of the following?

<table>
<thead>
<tr>
<th>Acid test (quick) ratio</th>
<th>Inventory turnover rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Numerator</td>
<td>Denominator</td>
</tr>
<tr>
<td>c. Not used</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. Not used</td>
<td>Numerator</td>
</tr>
</tbody>
</table>

Which of the following ratios is(are) useful in assessing a company's ability to meet currently maturing or short-term obligations?

<table>
<thead>
<tr>
<th>Acid-test ratio</th>
<th>Debt to equity ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
**Selected Questions**

**M88#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>

**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>

**M87#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>

**K. Development Stage Enterprises**

**N90#8.** Deficits accumulated during the development stage of a company should be
a. Reported as organization costs.
b. Reported as a part of stockholders’ equity.
c. Capitalized and written off in the first year of principal operations.
d. Capitalized and amortized over a five year period beginning when principal operations commence.

**M90#39.** ABC Co. was organized on July 15, 1987, and earned no significant revenues until the first quarter of 1990. During the period 1987–89, ABC acquired plant and equipment, raised capital, obtained financing, trained employees, and developed markets. In its fi-

nancial statements as of December 31, 1989, ABC should defer all costs incurred during 1987–89,
a. Net of revenues earned, which are recoverable in future periods.
b. Net of revenues earned.
c. Which are recoverable in future periods.
d. Without regard to net revenues earned or recoverability in future periods.

**N99#38.** A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

<table>
<thead>
<tr>
<th>Deferral of costs when incurred</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
</tr>
<tr>
<td>b. Yes</td>
</tr>
<tr>
<td>c. No</td>
</tr>
<tr>
<td>d. No</td>
</tr>
</tbody>
</table>

**M89#38.** A development stage enterprise
a. Issues an income statement that shows only cumulative amounts from the enterprise’s inception.
b. Issues an income statement that is the same as an established operating enterprise, but does not show cumulative amounts from the enterprise’s inception as additional information.
c. Issues an income statement that is the same as an established operating enterprise, and shows cumulative amounts from the enterprise’s inception as additional information.
d. Does not issue an income statement.

**M88#39.** A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

<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>

**L. Personal Financial Statements**

**M91#40.** Personal financial statements should report an investment in life insurance at the
a. Face amount of the policy less the amount of premiums paid.
b. Cash value of the policy less the amount of any loans against it.
c. Cash value of the policy less the amount of premiums paid.
d. Face amount of the policy less the amount of any loans against it.
Accounting Theory

N90#9. Personal financial statements should report assets and liabilities at
a. Historical cost.
b. Historical cost and, as additional information, at estimated current values at the date of the financial statements.
c. Estimated current values at the date of the financial statements.
d. Estimated current values at the date of the financial statements and, as additional information, at historical cost.

M90#40. A business interest that constitutes a large part of an individual's total assets should be presented in a personal statement of financial condition as
a. A single amount equal to the proprietorship equity.
b. A single amount equal to the estimated current value of the business interest.
c. A separate listing of the individual assets and liabilities, at cost.
d. Separate line items of both total assets and total liabilities, at cost.

N89#39. Personal financial statements should include which of the following statements?

<table>
<thead>
<tr>
<th>Financial condition</th>
<th>Changes in net worth</th>
<th>Cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M89#39. In a personal statement of financial condition, which of the following should be reported at estimated current values?

<table>
<thead>
<tr>
<th>Investments in closely held businesses</th>
<th>Investments in leaseholds</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>

N88#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>

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.

N87#39. Personal financial statements should include a

<table>
<thead>
<tr>
<th>Statement of financial condition</th>
<th>Statement of changes in financial position</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
</tr>
<tr>
<td>b. No</td>
<td>No</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M. Combined Financial Statements

N90#3. Combined statements may be used to present the results of operations of

<table>
<thead>
<tr>
<th>Unconsolidated subsidiaries</th>
<th>Companies under common management</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>

N89#40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

<table>
<thead>
<tr>
<th>Different fiscal periods</th>
<th>Foreign operations</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>

M89#40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

<table>
<thead>
<tr>
<th>Income taxes</th>
<th>Minority interest</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#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>
A. Nature of Cost Elements

M91#46. In developing a predetermined factory overhead application rate for use in a process costing system, which of the following could be used in the numerator and denominator?

<table>
<thead>
<tr>
<th>Numerator</th>
<th>Denominator</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Actual factory</td>
<td>Actual machine</td>
</tr>
<tr>
<td>b. Actual factory</td>
<td>Estimated machine</td>
</tr>
<tr>
<td>c. Estimated factory</td>
<td>Actual machine</td>
</tr>
<tr>
<td>d. Estimated factory</td>
<td>Estimated machine</td>
</tr>
</tbody>
</table>

N90#41. Wages earned by machine operators in producing the firm's product should be categorized as

<table>
<thead>
<tr>
<th>Direct labor</th>
<th>Controllable by machine operators' foreman</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>

M90#41. Indirect labor is a
a. Prime cost.
b. Conversion cost.
c. Period cost.
d. Nonmanufacturing cost.

N89#41. Direct labor is a

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Prime 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>

M89#41. Direct materials cost is a

<table>
<thead>
<tr>
<th>Conversion cost</th>
<th>Prime 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>

N88#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>

M88#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>

N87#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>

M87#41. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the denominator?

| a. Estimated direct labor hours. |
| b. Actual direct labor hours.    |
| c. Estimated factory overhead.   |
| d. Actual factory overhead.      |

B. Process and Job Order Costing

M91#42. A process costing system was used for a department that began operations in January 1991. Approximately the same number of physical units, at the same degree of completion, were in work in process at the end of both January and February. Monthly conversion costs are allocated between ending work in process and units completed. Compared to the FIFO method, would the weighted average method use the same or a greater number of equivalent units to calculate the monthly allocations?

Equivalent units for weighted average compared to FIFO

<table>
<thead>
<tr>
<th>January</th>
<th>February</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Same</td>
<td>Same</td>
</tr>
<tr>
<td>b. Greater number</td>
<td>Greater number</td>
</tr>
<tr>
<td>c. Greater number</td>
<td>Same</td>
</tr>
<tr>
<td>d. Same</td>
<td>Greater number</td>
</tr>
</tbody>
</table>

N90#42. A job order cost system uses a predetermined factory overhead rate based on expected volume and expected fixed cost. At the end of the year, underapplied overhead might be explained by which of the following situations?

<table>
<thead>
<tr>
<th>Actual volume</th>
<th>Actual fixed costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Greater than expected</td>
<td>Greater than expected</td>
</tr>
<tr>
<td>b. Greater than expected</td>
<td>Less than expected</td>
</tr>
<tr>
<td>c. Less than expected</td>
<td>Greater than expected</td>
</tr>
<tr>
<td>d. Less than expected</td>
<td>Less than expected</td>
</tr>
</tbody>
</table>
**Accounting Theory**

**M90#42.** In process 2, material G is added when a batch is 60 percent complete. Ending work-in-process units, which are 50 percent complete, would be included in the computation of equivalent units for

<table>
<thead>
<tr>
<th>Conversion costs</th>
<th>Material G</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**N89#42.** In a job order cost system, the use of indirect materials previously purchased usually is recorded as a decrease in

- a. Stores control.
- b. Work-in-process control.
- c. Factory overhead control.
- d. Factory overhead applied.

**M89#42.** In a process cost system, the application of factory overhead usually would be recorded as an increase in

- b. Work in process control.
- c. Factory overhead control.
- d. Finished goods control.

**N88#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>

**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.

**N87#41.** In a job order cost system using predetermined factory overhead rates, indirect materials usually are recorded initially as an increase in

- a. Work in process control.
- b. Factory overhead applied.
- c. Factory overhead control.
- d. Stores control.

**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.

**C. Standard Costing**

**M91#43.** During 1990, a department’s three-variance overhead standard costing system reported unfavorable spending and volume variances. The activity level selected for allocating overhead to the product was based on 80% of practical capacity. If 100% of practical capacity had been selected instead, how would the reported unfavorable spending and volume variances be affected?

<table>
<thead>
<tr>
<th>Spending variance</th>
<th>Volume variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increased</td>
<td>Unchanged</td>
</tr>
<tr>
<td>b. Increased</td>
<td>Increased</td>
</tr>
<tr>
<td>c. Unchanged</td>
<td>Increased</td>
</tr>
<tr>
<td>d. Unchanged</td>
<td>Unchanged</td>
</tr>
</tbody>
</table>

**N90**

**Item 43 is based on the following:**

The diagram below depicts a factory overhead flexible budget line DB and standard overhead application line OA. Activity is expressed in machine hours with Point V indicating the standard hours required for the actual output in September 1990. Point S indicates the actual machine hours (inputs) and actual costs in September 1990.

![Diagram](attachment:image.png)

43. Are the following overhead variances favorable or unfavorable?

<table>
<thead>
<tr>
<th>Volume (capacity) variance</th>
<th>Efficiency variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Favorable</td>
<td>Favorable</td>
</tr>
<tr>
<td>b. Favorable</td>
<td>Unfavorable</td>
</tr>
<tr>
<td>c. Unfavorable</td>
<td>Favorable</td>
</tr>
<tr>
<td>d. Unfavorable</td>
<td>Unfavorable</td>
</tr>
</tbody>
</table>

**M90#43.** In the following diagram, the line OW represents the standard labor cost at any output volume expressed in direct labor hours. Point S indicates the
actual output at standard cost, and Point A indicates the actual hours and actual cost required to produce S.

Which of the following variances are favorable or unfavorable?

<table>
<thead>
<tr>
<th>Rate variance</th>
<th>Efficiency variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Favorable</td>
<td>Unfavorable</td>
</tr>
<tr>
<td>b. Favorable</td>
<td>Favorable</td>
</tr>
<tr>
<td>c. Unfavorable</td>
<td>Unfavorable</td>
</tr>
<tr>
<td>d. Unfavorable</td>
<td>Favorable</td>
</tr>
</tbody>
</table>

N89#43. Which of the following variances would be useful in calling attention to a possible short-term problem in the control of overhead costs?

<table>
<thead>
<tr>
<th>Spending variance</th>
<th>Volume variance</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>

N88#43. Under the two-variance method for analyzing factory overhead, which of the following is used in the computation of the controllable (budget) variance?

<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>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>

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

M91#41. A department adds material at the beginning of a process and identifies defective units when the process is 40% complete. At the beginning of the period, there was no work in process. At the end of the period, the number of work in process units equaled the number of units transferred to finished goods. If all units in ending work in process were 66 2/3% complete, then ending work in process should be allocated

| a. 50% of all normal defective unit costs. |
| b. 40% of all normal defective unit costs. |
| c. 50% of the material costs and 40% of the conversion costs of all normal defective unit costs. |
| d. None of the normal defective unit costs. |

M90#44. The diagram below represents the production and sales relationships of joint products P and Q. Joint costs are incurred until split-off, then separable costs are incurred in refining each product. Market values of P and Q at split-off are used to allocate joint costs.

If the market value of P at split-off increases and all other costs and selling prices remain unchanged, then the gross margin of

<table>
<thead>
<tr>
<th>P</th>
<th>Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increases</td>
<td>Decreases</td>
</tr>
<tr>
<td>Increases</td>
<td>Increases</td>
</tr>
<tr>
<td>Decreases</td>
<td>Decreases</td>
</tr>
<tr>
<td>Decreases</td>
<td>Increases</td>
</tr>
</tbody>
</table>
Accounting Theory

N89#44. Actual sales values at the split-off point for joint products Y and Z are not known. For purposes of allocating joint costs to products Y and Z, the relative sales value at split-off method is used. An increase in the costs beyond split-off occurs for product Z, while those of product Y remain constant. If the selling prices of finished products Y and Z remain constant, the percentage of the total joint costs allocated to product Y and product Z would
   a. Decrease for product Y and increase for product Z.
   b. Decrease for product Y and product Z.
   c. Increase for product Y and decrease for product Z.
   d. Increase for product Y and product Z.

M89#44. Spoilage from a manufacturing process was discovered during an inspection of work in process. In a process costing system, the cost of the spoilage would be added to the cost of the good units produced if the spoilage is

<table>
<thead>
<tr>
<th>Abnormal</th>
<th>Normal</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

N88#44. The sale of scrap from a manufacturing process usually would be recorded as (an)
   a. Decrease in factory overhead control.
   b. Increase in factory overhead control.
   c. Decrease in finished goods control.
   d. Increase in finished goods control.

M88#44. In accounting for byproducts, the value of the byproduct may be recognized at the time of

<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>

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>

E. Absorption and Variable Costing

M91#45. In an income statement prepared as an internal report using the direct (variable) costing method, fixed selling and administrative expenses would
   a. Be used in the computation of the contribution margin.
   b. Be used in the computation of operating income but not in the computation of the contribution margin.
   c. Be treated the same as variable selling and administrative expenses.
   d. Not be used.

N90

Item 44 is based on the following:

The diagram below depicts a factory overhead flexible budget line DB and standard overhead application line OA. Activity is expressed in machine hours with Point V indicating the standard hours required for the actual output in September 1990. Point S indicates the actual machine hours (inputs) and actual costs in September 1990.

44. The budgeted total variable overhead cost for C machine hours is
   a. AB
   b. BC
   c. AC minus DO
   d. BC minus DO

M90#45. A manufacturing company prepares income statements using both absorption and variable costing methods. At the end of a period actual sales revenues, total gross profit, and total contribution margin approximated budgeted figures, whereas net income was substantially below the budgeted amount. There were no beginning or ending inventories. The most likely explanation of the net income shortfall is that, compared to budget, actual
   a. Sales prices and variable costs had declined proportionately.
   b. Sales prices had declined proportionately more than variable costs.
   c. Manufacturing fixed costs had increased.
   d. Selling and administrative fixed expenses had increased.

N89#46. In an income statement prepared as an internal report, total fixed costs normally would be shown separately under
Selected Questions

<table>
<thead>
<tr>
<th>Absorption costing</th>
<th>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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M98#45. In an income statement prepared using the variable costing method, fixed factory overhead would
a. Not be used.
b. Be used in the computation of the contribution margin.
c. Be used in the computation of operating income but not in the computation of the contribution margin.
d. Be treated the same as variable factory overhead.

M88#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>

M88#45. In an income statement prepared as an internal report using the variable costing method, variable selling and administrative expenses would
a. Not be used.
b. Be treated the same as fixed selling and administrative expenses.
c. Be used in the computation of operating income but not in the computation of the contribution margin.
d. Be used in the computation of the contribution margin.

M87#46. In an income statement prepared as an internal report using the variable costing method, which of the following terms should appear?

<table>
<thead>
<tr>
<th>Gross profit (margin)</th>
<th>Operating income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

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>

F. Budgeting and Flexible Budgeting

M91#44. Lanta Restaurant compares monthly operating results with a static budget. When actual sales are less than budget, would Lanta usually report favorable variances on variable food costs and fixed supervisory salaries?

<table>
<thead>
<tr>
<th>Variable food costs</th>
<th>Fixed supervisory salaries</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>

N90#45. When a manager is concerned with monitoring total cost, total revenue, and net profit conditioned upon the level of productivity, an accountant would normally recommend

<table>
<thead>
<tr>
<th>Flexible budgeting</th>
<th>Standard 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>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M90

Item 46 is based on the following:

The diagram below is a cost-volume-profit chart.

46. At point A compared to point B, as a percentage of sales revenues

<table>
<thead>
<tr>
<th>Variable costs are</th>
<th>Fixed costs are</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Greater</td>
<td>Greater</td>
</tr>
<tr>
<td>b. Greater</td>
<td>The same</td>
</tr>
<tr>
<td>c. The same</td>
<td>The same</td>
</tr>
<tr>
<td>d. The same</td>
<td>Greater</td>
</tr>
</tbody>
</table>

N99#45. When a flexible budget is used, a decrease in production levels within a relevant range would

a. Increase total fixed costs.
b. Increase variable cost per unit.
c. Decrease variable cost per unit.
d. Decrease total costs.
M89#46. A flexible budget is appropriate for a (an)

<table>
<thead>
<tr>
<th>Administrative budget</th>
<th>Marketing budget</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>

M89#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.

M89#46. 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>

M90

Item 47 is based on the following:

The diagram below is a cost-volume-profit chart.

47. If sales dollars are used to measure activity levels, total costs and total revenues may be read from the X and Y axes as follows:

<table>
<thead>
<tr>
<th>Total costs</th>
<th>Total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. X or Y</td>
<td>X or Y</td>
</tr>
<tr>
<td>b. X or Y</td>
<td>X only</td>
</tr>
<tr>
<td>c. Y only</td>
<td>X or Y</td>
</tr>
<tr>
<td>d. Y only</td>
<td>X only</td>
</tr>
</tbody>
</table>

N90

Breakeven analysis assumes that over the relevant range

a. Unit variable costs are unchanged.
b. Total fixed costs are nonlinear.
c. Unit revenues are nonlinear.
d. Total costs are unchanged.

M89#47. Breakeven analysis assumes that over the relevant range

a. Total costs are unchanged.
b. Unit variable costs are unchanged.
c. Variable costs are nonlinear.
d. Unit fixed costs are unchanged.

N90

Breakeven analysis assumes that over the range total

a. Revenues are linear.
b. Costs are unchanged.
c. Variable costs are nonlinear.
d. Fixed costs are nonlinear.
Selected Questions

M88#47. Breakeven analysis assumes that over the relevant range
   a. Variable costs are nonlinear.
   b. Fixed costs are nonlinear.
   c. Selling prices are unchanged.
   d. Total costs are unchanged.

N87#48. In using cost-volume-profit analysis to calculate expected unit sales, which of the following should be added to fixed costs in the numerator?
   a. Predicted operating loss.
   b. Predicted operating profit.
   c. Unit contribution margin.
   d. Variable costs.

M87#47. Breakeven analysis assumes over the relevant range that
   a. Total costs are linear.
   b. Fixed costs are nonlinear.
   c. Variable costs are nonlinear.
   d. Selling prices are nonlinear.

H. Capital Budgeting Techniques

M91#48. The discount rate (hurdle rate of return) must be determined in advance for the
   a. Payback period method.
   b. Time adjusted rate of return method.
   c. Net present value method.
   d. Internal rate of return method.

N90#46. On November 1, 1990, a company purchased a new machine that it does not have to pay for until November 1, 1992. The total payment on November 1, 1992, will include both principal and interest. Assuming interest at a 10% rate, the cost of the machine would be the total payment multiplied by what time value of money concept?
   a. Present value of annuity of 1.
   b. Present value of 1.
   c. Future amount of annuity of 1.
   d. Future amount of 1.

N90#47. Which of the following capital budgeting techniques implicitly assumes that the cash flows are reinvested at the company's minimum required rate of return?

<table>
<thead>
<tr>
<th>Net present value</th>
<th>Internal rate of return</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>

M90#48. Polo Co. requires higher rates of return for projects with a life span greater than five years. Projects extending beyond five years must earn a higher specified rate of return. Which of the following capital bud-

ggeting techniques can readily accommodate this requirement?

<table>
<thead>
<tr>
<th>Internal rate of return</th>
<th>Net present value</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N89#48. The capital budgeting technique known as accounting rate of return uses

<table>
<thead>
<tr>
<th>Revenue over life of project</th>
<th>Depreciation expense</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>

N89#48. The capital budgeting technique known as payback period uses

<table>
<thead>
<tr>
<th>Depreciation expense</th>
<th>Time value of money</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N88#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>

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>
</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#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.

I. Performance Analysis

M91#47. Controllable revenues would be included in the performance reports of which of the following types of responsibility centers?

<table>
<thead>
<tr>
<th>Cost centers</th>
<th>Investment centers</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
</tr>
<tr>
<td>b.</td>
<td>Yes</td>
</tr>
<tr>
<td>c.</td>
<td>No</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
</tr>
</tbody>
</table>

M90#48. Division A is considering a project that will earn a rate of return which is greater than the imputed interest charge for invested capital, but less than the division's historical return on invested capital. Division B is considering a project that will earn a rate of return which is greater than the division's historical return on invested capital, but less than the imputed interest charge for invested capital. If the objective is to maximize residual income, should these divisions accept or reject their projects?

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Accept</td>
<td>Accept</td>
</tr>
<tr>
<td>b.</td>
<td>Reject</td>
<td>Accept</td>
</tr>
<tr>
<td>c.</td>
<td>Reject</td>
<td>Reject</td>
</tr>
<tr>
<td>d.</td>
<td>Accept</td>
<td>Reject</td>
</tr>
</tbody>
</table>

M90#49. A company's return on investment is the

a. Profit margin percentage divided by the capital turnover.
b. Profit margin percentage multiplied by the capital turnover.
c. Capital turnover divided by invested capital.
d. Capital turnover multiplied by invested capital.

N89#49. A company is analyzing the performance of responsibility centers. Controllable revenues would be included in the performance reports of which of the following types of responsibility centers?

<table>
<thead>
<tr>
<th>Investment centers</th>
<th>Profit centers</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M89#49. Residual income is income

a. To which an imputed interest charge for invested capital is added.
b. From which an imputed interest charge for invested capital is deducted.
c. From which dividends are deducted.
d. To which dividends are added.

N88#49. The calculation of a company's return on investment is affected by a change in

<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>

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>

N87#44. Residual income is the

a. Contribution margin of an investment center, less the imputed interest on the invested capital used by the center.
b. Contribution margin of an investment center, plus the imputed interest on the invested capital used by the center.
c. Income of an investment center, less the imputed interest on the invested capital used by the center.
d. Income of an investment center, plus the imputed interest on the invested capital used by the center.

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.

J. Other

M91#50. The economic order quantity formula assumes that

a. Purchase costs per unit differ due to quantity discounts.
b. Costs of placing an order vary with quantity ordered.
Selected Questions

c. Periodic demand for the good is known.
d. Erratic usage rates are cushioned by safety stocks.

N90#49. When only differential manufacturing costs are taken into account for special order pricing, an essential assumption is that
a. Manufacturing fixed and variable costs are linear.
b. Selling and administrative fixed and variable costs are linear.
c. Acceptance of the order will not affect regular sales.
d. Acceptance of the order will not cause unit selling and administrative variable costs to increase.

N90#50. Which of the following may be used to estimate how inventory warehouse costs are affected by both the number of shipments and the weight of materials handled?
a. Economic order quantity analysis.
b. Probability analysis.
c. Correlation analysis.
d. Multiple regression analysis.

M90#50. In statistical analysis, a weighted average using probabilities as weights is the
a. Objective function.
b. Coefficient of variation.
c. Expected value.
d. Standard deviation.

N89#50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is (are) economically relevant to the decision?

<table>
<thead>
<tr>
<th>Original cost of old asset</th>
<th>Fair market value of old asset</th>
<th>Inventory carrying cost</th>
<th>Stockout cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>Not used</td>
<td>Denominator</td>
</tr>
</tbody>
</table>

M89#50. 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>

N88#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>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>

N87#50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following formulas would be included in the economic order quantity formula?

<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>Original cost of old asset</th>
<th>Fair market value of old asset</th>
<th>Inventory carrying cost</th>
<th>Cost per purchase order</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Numerator</td>
<td>Numerator</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
<td>Denominator</td>
<td>Numerator</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
<td>Denominator</td>
<td>Denominator</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
<td>Not used</td>
<td>Denominator</td>
</tr>
</tbody>
</table>
Accounting Theory

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

**M91#51.** The primary authoritative body for determining the measurement focus and basis of accounting standards for governmental fund operating statements is the

a. Governmental Accounting Standards Board (GASB).


c. Government Accounting and Auditing Committee of the AICPA (GAAC).

d. Financial Accounting Standards Board (FASB).

**N90#51.** Which of the following bases of accounting should a government use for its proprietary funds in measuring financial position and operating results?

<table>
<thead>
<tr>
<th>Modified accrual basis</th>
<th>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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**M90#59.** Fixed assets donated to a governmental unit should be recorded

a. As a memorandum entry only.

b. At the donor’s carrying amount.

c. At estimated fair value when received.

d. At the lower of donor’s carrying amount or estimated fair value when received.

**N89#51.** The modified accrual basis of accounting is appropriate for which of the following fund categories of a county government?

<table>
<thead>
<tr>
<th>Governmental</th>
<th>Proprietary</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>

**M89#51.** Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they

a. Are earned and become measurable.

b. Are collected.

c. Become available and measurable.

d. Become available and earned.

**N88#51.** Which of the following is an appropriate basis of accounting for a proprietary fund of a governmental unit?

<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>

**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>

B. Fund Accounting

**M91#52.** The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is

a. Credited at the beginning of the year and debited at the end of the year.

b. Credited at the beginning of the year and not changed at the end of the year.

c. Debited at the beginning of the year and credited at the end of the year.

d. Debited at the beginning of the year and not changed at the end of the year.

**M91#53.** Which of the following amounts are included in a general fund’s encumbrance account?

I. Outstanding vouchers payable amounts.

II. Outstanding purchase order amounts.

III. Excess of the amount of a purchase order over the actual expenditure for that order.

a. I only.

b. I and III.

c. II only.

d. II and III.

**M90**

Items 52 and 54 are based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd’s other governmental units.
During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd’s 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor’s office.

52. In reporting the state grants for the bus purchase and operation, what should Todd include as grant revenues for the year ended December 31, 1989?

<table>
<thead>
<tr>
<th>90% of the capital grant</th>
<th>100% of the capital grant</th>
<th>Operating grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
<td>No</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>

54. When Todd records its annual budget, which of the following control accounts indicates the amount of the authorized spending limitation for the year ending December 31, 1989?

a. Reserved for appropriations.
b. Appropriations.
c. Reserved for encumbrances.
d. Encumbrances.

M89#52. The encumbrances control account of a governmental unit is increased when

<table>
<thead>
<tr>
<th>A voucher payable is recorded</th>
<th>The budgetary accounts are closed</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>

M89#53. The expenditures control account of a governmental unit is increased when

<table>
<thead>
<tr>
<th>A purchase order is approved</th>
<th>The budget is recorded</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>

M89#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.

M87#52. The estimated revenues control account of a governmental unit is debited when

a. The budget is closed at the end of the year.
b. The budget is recorded.
c. Actual revenues are recorded.
d. Actual revenues are collected.

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.
Accounting Theory

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.

C. Types of Funds and Account Groups

M91#54. Tott City’s serial bonds are serviced through a debt service fund with cash provided by the general fund. In a debt service fund’s statements, how are cash receipts and cash payments reported?

<table>
<thead>
<tr>
<th>Cash receipts</th>
<th>Cash payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Revenues</td>
<td>Expenditures</td>
</tr>
<tr>
<td>b. Revenues</td>
<td>Operating transfers</td>
</tr>
<tr>
<td>c. Operating transfers</td>
<td>Expenditures</td>
</tr>
<tr>
<td>d. Operating transfers</td>
<td>Operating transfers</td>
</tr>
</tbody>
</table>

M91#55. Taxes collected and held by Eldorado County for a school district would be accounted for in which of the following funds?
  a. Trust.
  b. Agency.
  c. Special revenue.
  d. Internal service.

M91#56. Old equipment, which is recorded in the general fixed asset account group, is sold for less than its carrying amount. The sale reduces the investments in general fixed assets’ balance by the
  a. Difference between the cost of the equipment and the sales price.
  b. Difference between the carrying amount of the equipment and the sales price.
  c. Selling price of the equipment.
  d. Carrying amount of the equipment.

M91#57. An alumnus donates securities to Rex College and stipulates that the principal be held in perpetuity and revenues be used for faculty travel. Dividends received from the securities should be recognized as revenues in
  a. Endowment funds.
  b. Quasi-endowment funds.
  c. Restricted current funds.
  d. Unrestricted current funds.

M91#58. A college’s plant funds group includes which of the following subgroups?
  I. Renewals and replacement funds.
  II. Retirement of indebtedness funds.
  III. Restricted current funds.
  a. I and II.
  b. I and III.
  c. II and III.
  d. I only.

N90#52. Which of the following fund types used by a government most likely would have a Fund Balance Reserved for Inventory of Supplies?
  a. General.
  b. Internal service.
  c. Nonexpendable trust.
  d. Capital projects.

N90#53. Should a special revenue fund with a legally adopted budget maintain its accounts on an accrual basis and integrate budgetary accounts into its accounting system?

<table>
<thead>
<tr>
<th>Maintain on accrual basis</th>
<th>Integrate budgetary accounts</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>

N90
Items 54 through 57 are based on the following:

On March 2, 1990, Finch City issued 10-year general obligation bonds at face amount, with interest payable March 1 and September 1. The proceeds were to be used to finance the construction of a civic center over the period April 1, 1990, to March 31, 1991. During the fiscal year ended June 30, 1990, no resources had been provided to the debt service fund for the payment of principal and interest.

54. On June 30, 1990, Finch’s debt service fund should include interest payable on the general obligation bonds for
  a. 0 months.
  b. 3 months.
  c. 4 months.
  d. 6 months.

55. Proceeds from the general obligation bonds should be recorded in the
  a. General fund.
  b. Capital projects fund.
  c. General long-term debt account group.
  d. Debt service fund.
Selected Questions

56. The liability for the general obligation bonds should be recorded in the
   a. General fund.
   b. Capital projects fund.
   c. General long-term debt account group.
   d. Debt service fund.

57. On June 30, 1990, Finch's combined balance sheet should report the construction in progress for the civic center in the

<table>
<thead>
<tr>
<th>Capital projects fund</th>
<th>General fixed assets 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

N90#58. Which of the following fund types or account group should account for fixed assets in a manner similar to a "for profit" organization?
   a. Special revenue fund.
   b. Capital projects fund.
   c. General fixed assets account group.
   d. Enterprise fund.

N90#59. Which of the following fund types would include retained earnings in its balance sheet?
   a. Special revenue.
   b. Capital projects.
   c. Expendable pension trust.
   d. Internal service.

M90

Items 51 and 53 are based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units.

During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd’s full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

51. To record the billing for data processing services provided to Todd's other governmental units, the internal service fund should credit
   a. Operating revenues.
   b. Data processing departmental expenses.
   c. Intergovernmental transfers.
   d. Interfund exchanges.

53. Which of Todd's long-term obligations should be accounted for in the general long-term debt account group?

<table>
<thead>
<tr>
<th>General obligation bonds</th>
<th>Revenue bonds</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>

M90#56. Revenues that are legally restricted to expenditures for specified purposes should be accounted for in special revenue funds, including
   a. Accumulation of resources for payment of general long-term debt principal and interest.
   b. Pension trust fund revenues.
   c. Gasoline taxes to finance road repairs.
   d. Proprietary fund revenues.

M90#57. The basis of accounting for a capital projects fund is the
   a. Cash basis.
   b. Accrual basis.
   c. Modified cash basis.
   d. Modified accrual basis.

M89#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>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>

M89#55. Which of the following funds of a governmental unit uses the same basis of accounting as the enterprise fund?
   a. Nonexpendable trust funds.
   b. Expendable trust funds.
   c. Special revenue funds.
   d. Capital projects funds.
**Accounting Theory**

**N89#56.** Fixed assets should be accounted for in the general fixed assets account group for the

<table>
<thead>
<tr>
<th>Enterprise fund</th>
<th>Special revenue fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

**N89#57.** Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable debt securities and a portion in marketable equity securities. How would each portion be classified in the balance sheet?

<table>
<thead>
<tr>
<th>Portion in marketable debt securities</th>
<th>Portion in marketable equity securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Unrestricted asset</td>
<td>Restricted asset</td>
</tr>
<tr>
<td>b. Unrestricted asset</td>
<td>Unrestricted asset</td>
</tr>
<tr>
<td>c. Restricted asset</td>
<td>Unrestricted asset</td>
</tr>
<tr>
<td>d. Restricted asset</td>
<td>Restricted asset</td>
</tr>
</tbody>
</table>

**N88#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>

**N88#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>

**M88#54.** Which of the following funds of a governmental unit is a governmental fund?

a. Enterprise funds.

b. Internal service funds.

c. Debt service funds.

d. Nonexpendable trust funds.

**M88#55.** Fixed assets of an enterprise fund should be accounted for in the

a. Enterprise fund but no depreciation on the fixed assets should be recorded.

b. Enterprise fund and depreciation on the fixed assets should be recorded.

c. General fixed asset account group but no depreciation on the fixed assets should be recorded.

d. General fixed asset account group and depreciation on the fixed assets should be recorded.

**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?

<table>
<thead>
<tr>
<th>Portion in cash</th>
<th>Portion in marketable securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Restricted asset</td>
<td>Restricted asset</td>
</tr>
<tr>
<td>b. Restricted asset</td>
<td>Unrestricted asset</td>
</tr>
<tr>
<td>c. Unrestricted asset</td>
<td>Unrestricted asset</td>
</tr>
<tr>
<td>d. Unrestricted asset</td>
<td>Restricted asset</td>
</tr>
</tbody>
</table>
Selected Questions

M87#54. Which of the following funds of a government unit recognizes revenues in the accounting period in which they become available and measurable?
- Nonexpendable trust.
- General.
- Enterprise.
- Internal service.

M87#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>

M87#56. Which of the following funds of a governmental unit uses the same basis of accounting as an enterprise fund?
- Special revenue.
- Expendable trust.
- Capital projects.
- Internal service.

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
- Quasi-endowment fund.
- Endowment fund.
- Agency fund.
- Current fund-restricted.

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

M91#59. In a government's comprehensive annual financial report (CAFR), account groups are included in which of the following combined financial statements?

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>expenditure, and changes in fund balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

M90#60. An increase in Oak College's restricted current funds balance could be reported as an excess of
- Transfers to revenues over restricted receipts.
- Restricted receipts over transfers to revenues.
- Revenues over expenditures and mandatory transfers.
- Revenues and mandatory transfers over expenditures.

M90

Item 55 is based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units.

During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of
the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd’s full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd’s 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor’s office.

55. In Todd’s general fund balance sheet presentation at December 31, 1989, which of the following expenditures should be classified as fixed assets?

<table>
<thead>
<tr>
<th>Structural alterations to firehouse</th>
<th>Mayor’s office furniture</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>

**M89#60.** The comprehensive annual financial report (CAFR) of a city should contain a combined statement of revenues, 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>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>

**M88#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, 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>

**M88#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in fund balances 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>

**E. Various Types of Not-for-Profit and Governmental Organizations**

**M90#58.** For state and local governmental units, generally accepted accounting principles require that encumbrances outstanding at year-end be reported as

a. Expenditures.
b. Reservations of fund balance.
c. Deferred liabilities.
d. Current liabilities.

**M90#60.** Which of the following should be included in a university’s current funds revenue?

<table>
<thead>
<tr>
<th>Unrestricted gifts</th>
<th>Expended restricted current funds</th>
<th>Unexpended restricted current funds</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>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Selected Questions

M89#58. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, depreciation expense should

a. Be included as an element of expense.
b. Be included as an element of other changes in fund balances.
c. Be included as an element of support.
d. Not be included.

M89#59. A local governmental unit could have funds using which of the following accounting bases?

<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>

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>

M87#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>

M87#60. The current funds group of a not-for-profit private university includes which of the following?

<table>
<thead>
<tr>
<th>Agency funds</th>
<th>Plant funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
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>E. Consolidated Financial Statements</th>
<th>F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>M91# 1 a</td>
<td>N90# 2 c</td>
<td>M91# 2 a</td>
</tr>
<tr>
<td>N90# 1 a</td>
<td>M90# 2 a</td>
<td>M91# 3 b</td>
</tr>
<tr>
<td>M90# 1 d</td>
<td>M88# 3 b</td>
<td>N90# 11 b</td>
</tr>
<tr>
<td>N89# 1 d</td>
<td></td>
<td>M90# 3 d</td>
</tr>
<tr>
<td>M89# 1 a</td>
<td></td>
<td>M88# 4 d</td>
</tr>
<tr>
<td>N88# 1 b</td>
<td></td>
<td>M87# 2 a</td>
</tr>
<tr>
<td>M88# 1 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88# 2 b</td>
<td></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>B. Receivables and Accruals</th>
<th>N89# 9 c</th>
<th>N87# 4 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>M91# 4 b</td>
<td>M91#10 a</td>
<td>N89#10 b</td>
<td>N87# 5 b</td>
</tr>
<tr>
<td>N90# 6 d</td>
<td>N89# 6 b</td>
<td>N88# 6 a</td>
<td>N87# 6 b</td>
</tr>
<tr>
<td>M90# 4 b</td>
<td>N89# 7 a</td>
<td>N88# 8 b</td>
<td>N87# 7 c</td>
</tr>
<tr>
<td>N89# 2 d</td>
<td>M89# 2 b</td>
<td>N87# 1 a</td>
<td></td>
</tr>
<tr>
<td>N89# 3 d</td>
<td>M89# 3 c</td>
<td>N87# 2 c</td>
<td></td>
</tr>
<tr>
<td>N89# 4 d</td>
<td>M88# 7 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N89# 5 a</td>
<td>M87# 3 b</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N88# 2 b</td>
<td>M87# 4 d</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N88# 3 b</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N88# 4 c</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N88# 5 d</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88# 5 a</td>
<td>N90#15 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M88# 6 c</td>
<td>N90#16 a</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 5 a</td>
<td>N90#17 c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M87# 8 a</td>
<td>N89# 8 d</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. Inventories</th>
<th>D. Property, Plant, and Equipment Owned or Leased</th>
<th>M91#11 c</th>
</tr>
</thead>
<tbody>
<tr>
<td>N90#13 a</td>
<td>M90# 5 b</td>
<td></td>
</tr>
<tr>
<td>N89#12 c</td>
<td>M89# 6 c</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>A. Payables and Accruals</th>
<th>M90# 8 b</th>
<th>B. Deferred Revenues</th>
<th>M88#12 b</th>
</tr>
</thead>
<tbody>
<tr>
<td>M90#13 d</td>
<td>N89#13 c</td>
<td>M91#15 d</td>
<td>N87#10 d</td>
</tr>
<tr>
<td>N88#10 b</td>
<td></td>
<td>N90#23 a</td>
<td></td>
</tr>
<tr>
<td>M91#14 d</td>
<td>M88#11 a</td>
<td>N90#24 d</td>
<td></td>
</tr>
<tr>
<td>M87#10 b</td>
<td></td>
<td>M90# 9 b</td>
<td></td>
</tr>
<tr>
<td>N90#20 b</td>
<td></td>
<td>N89#14 b</td>
<td></td>
</tr>
<tr>
<td>N90#22 a</td>
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Accounting Theory

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

M91
Number 3 (Estimated time — — 15 to 25 minutes)

Happlia Co. imports expensive household appliances. Each model has many variations and each unit has an identification number. Happlia pays all costs for getting the goods from the port to its central warehouse in Des Moines. After repackaging, the goods are consigned to retailers. A retailer makes a sale, simultaneously buys the appliance from Happlia, and pays the balance due within one week.

To alleviate the overstocking of refrigerators at a Minneapolis retailer, some were reshipped to a Kansas City retailer where they were still held in inventory at December 31, 1990. Happlia paid the costs of this reshipment.

Happlia uses the specific identification inventory costing method.

Required:

a. In regard to the specific identification inventory costing method
   1. Describe its key elements.
   2. Discuss why it is appropriate for Happlia to use this method.

b. 1. What general criteria should Happlia use to determine inventory carrying amounts at December 31, 1990? Ignore lower of cost or market considerations.
   2. Give four examples of costs included in these inventory carrying amounts.

c. What costs should be reported in Happlia’s 1990 income statement? Ignore lower of cost or market considerations.

M90
Number 2 (Estimated time — — 15 to 25 minutes)

Grumer’s common stock does not have a quoted market price. The stock has always been issued at its book value, which is assumed to approximate its fair value.

Required:

a. In general, distinguish between investor income reporting under the cost method and under the equity method. Which method is more consistent with accrual accounting? Why?

b. Prior to January 2, 1990, what specific factors should Monroe have considered in determining the appropriate method of accounting for its investment in Grumer?

c. For purposes of your answer to c only, assume Monroe used the cost method in accounting for its investment in Grumer prior to January 2, 1990. Describe the book adjustments required on January 2, 1990, when Monroe became owner of 30% of the outstanding common stock of Grumer.

M90
Number 2 (Estimated time — — 15 to 25 minutes)

Magrath Company has an operating cycle of less than one year and provides credit terms for all of its customers. On April 1, 1989, the company factored, without recourse, some of its accounts receivable.

On July 1, 1989, Magrath sold special order merchandise and received a noninterest-bearing note due June 30, 1991. The market rate of interest for this note is determinable.

Magrath uses the allowance method to account for uncollectible accounts. During 1989, some accounts were written off as uncollectible and other accounts previously written off as uncollectible were collected.

Required:

a. How should Magrath account for and report the accounts receivable factored on April 1, 1989? Why is this accounting treatment appropriate?

b. How should Magrath report the effects of the noninterest-bearing note on its income statement for the year ended December 31, 1989, and its December 31, 1989 balance sheet?
c. How should Magrath account for the collection of the accounts previously written off as uncollectible?

d. What are the two basic approaches to estimating uncollectible accounts under the allowance method? What is the rationale for each approach?

M90
Number 4 (Estimated time — 15 to 25 minutes)

Huddell Company, which is both a wholesaler and retailer, purchases merchandise from various suppliers FOB destination, and incurs substantial warehousing costs.

The dollar value LIFO method is used for the wholesale inventories.

Huddell determines the estimated cost of its retail ending inventories using the conventional retail inventory method, which approximates lower of average cost or market.

Required:

a. When should the purchases from various suppliers generally be included in Huddell's inventory? Why?

b. How should Huddell account for the warehousing costs? Why?

c. 1. What are the advantages of using the dollar value LIFO method as opposed to the traditional LIFO method?
   2. How does the application of the dollar value LIFO method differ from the application of the traditional LIFO method?

d. 1. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Huddell use
   • Net markups?
   • Net markdowns?
   2. Why does Huddell’s retail inventory method approximate lower of average cost or market?

M99
Number 2 (Estimated time — 15 to 25 minutes)

Bristol Company purchased land as a site for construction of a factory. Outside contractors were engaged to:

• Construct the factory.

• Grade and pave a parking lot adjacent to the factory for the exclusive use of the factory workers.

Operations at the new location began during the year and normal factory maintenance costs were incurred after production began.

Required:

a. Distinguish between capital and revenue expenditures.

b. Indicate how expenditures for each of the following should be accounted for and reported by Bristol at the time incurred and in subsequent accounting periods.
   1. Purchase of land.
   2. Construction of factory.
   3. Grading and paving parking lot.
   4. Payment of normal factory maintenance costs.

Do not discuss capitalization of interest during construction in your response.

M99
Number 2 (Estimated time — 15 to 25 minutes)

Vane Company has two portfolios of marketable equity securities. One is classified as a current asset, and the other is classified as a noncurrent asset. Vane does not have the ability to exercise significant influence over any of the companies in either portfolio. Some securities from each portfolio were sold during the year. One of the securities in the current portfolio was reclassified to the noncurrent portfolio when its market value was less than cost. At the beginning and end of the year, the aggregate cost of each portfolio exceeded its aggregate market value by different amounts.

Required:

a. How should Vane measure and report the income statement effects of the securities sold during the year from each portfolio?

b. How should Vane account for the security which was reclassified from the current asset portfolio to the noncurrent asset portfolio?

c. How should Vane report the effects of investments in each portfolio in its balance sheet as of the end of the year and its income statement for the year? Why? Do not discuss the securities sold.

M99
Number 3 (Estimated time — 15 to 25 minutes)

Steel Company, a wholesaler that has been in business for two years, purchases its inventories from various suppliers. During the two years, each purchase has been at a lower price than the previous purchase.

Steel uses the lower of FIFO cost or market method to value inventories. The original cost of the inventories is above replacement cost and below the net realizable value. The net realizable value less the normal profit margin is below the replacement cost.

Required:

a. In general, what criteria should be used to determine which costs should be included in inventory?
Selected Questions

b. In general, why is the lower of cost or market rule used to report inventory?

c. At what amount should Steel's inventories be reported on the balance sheet? Explain the application of the lower of cost or market rule in this situation.

d. What would have been the effect on ending inventories and net income for the second year had Steel used the lower of average cost or market inventory method instead of the lower of FIFO cost or market inventory method? Why?

N88
Number 2 (Estimated time — 15 to 25 minutes)

Hogan Company uses the net method of accounting for sales discounts. Hogan also offers trade discounts to various groups of buyers.

On August 1, 1987, Hogan factored some accounts receivable on a without recourse basis. Hogan incurred a finance charge.

Hogan also has some notes receivable bearing an appropriate rate of interest. The principal and total interest are due at maturity. The notes were received on October 1, 1987, and mature on September 30, 1989. Hogan's operating cycle is less than one year.

Required:

a. 1. Using the net method, how should Hogan account for the sales discounts at the date of sale? What is the rationale for the amount recorded as sales under the net method?

2. Using the net method, what is the effect on Hogan's sales revenues and net income when customers do not take the sales discounts?

b. What is the effect of trade discounts on sales revenues and accounts receivable? Why?

c. How should Hogan account for the accounts receivable factored on August 1, 1987? Why?

d. How should Hogan report the effects of the interest-bearing notes receivable on its December 31, 1987, balance sheet and its income statement for the year ended December 31, 1987? Why?

N88
Number 3 (Estimated time — 15 to 25 minutes)

At the beginning of the year, Patrick Company acquired a computer to be used in its operations. The computer was delivered by the supplier, installed by Patrick, and placed into operation. The estimated useful life of the computer is five years, and its estimated residual (salvage) value is significant.

During the year, Patrick received cash in exchange for an automobile that was purchased in a prior year.

Required:

a. 1. What costs should Patrick capitalize for the computer?

2. What is the objective of depreciation accounting? Do not discuss specific methods of depreciation.

b. What is the rationale for using accelerated depreciation methods?

c. How should Patrick account for and report the disposal of the automobile?

M88
Number 2 (Estimated time — 15 to 25 minutes)

Hudson Company, which is both a wholesaler and a retailer, purchases its inventories from various suppliers.

Additional facts for Hudson's wholesale operations are as follows:

- Hudson incurs substantial warehousing costs.
- Hudson uses the lower of cost or market method.
- The replacement cost of the inventories is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventories is above the replacement cost and below the net realizable value.

Additional facts for Hudson's retail operations are as follows:

- Hudson determines the estimated cost of its ending inventories held for sale at retail using the conventional retail inventory method, which approximates lower of average cost or market.
- Hudson incurs substantial freight-in costs.
- Hudson has net markups and net markdowns.

Required:

a. Theoretically, how should Hudson account for the warehousing costs related to its wholesale inventories? Why?

b. 1. In general, why is the lower of cost or market method used to report inventory?

2. At which amount should Hudson's wholesale inventories be reported on the balance sheet? Explain the application of the lower of cost or market method in this situation.

c. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Hudson treat

1. Freight-in costs?

2. Net markups?

3. Net markdowns?

d. Why does Hudson's retail inventory method approximate lower of average cost or market?
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?

Houston Company has a portfolio of marketable equity securities that it classifies as a current asset. Houston owns less than five percent of the outstanding voting stock of each company's securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its aggregate cost. Cash dividends on these securities were received during the year. All cash dividends received represent distributions of earnings subsequent to Houston's acquisition of these securities. Some of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its aggregate market value.

Houston owns forty percent of the outstanding voting stock of Joy Company. The remainder of Joy's outstanding voting stock is widely dispersed among unrelated investors.

**Required:**

a. 1. How should Houston report the income statement effects of the cash dividends received during the year on the securities in the portfolio that it classifies as a current asset?
   2. How should Houston report the income statement effects of the securities sold during the year?

b. How should Houston report the effect of ownership of the portfolio that it classifies as a current asset in its balance sheet as of the end of the year and income statement for the year? Why? Do not discuss the cash dividends or the securities sold.

c. Identify the method of accounting that Houston should use for its forty percent investment in the outstanding voting stock of Joy. Why is this method appropriate?
has been at a lower price than the previous purchase, and the ending inventory quantity for each period has been higher than the beginning inventory quantity for that period.

Required:

a. What is the theoretically appropriate method that Hanlon should use to account for the insurance costs on the raw materials while they were in transit from the supplier? Why?

b. 1. At which amount should Hanlon's raw materials inventory be reported on the balance sheet? Why?
   2. In general, why is the lower of cost or market rule used to report inventory?
   3. What would have been the effect on ending inventory and cost of goods sold had Hanlon used the LIFO inventory method instead of the average cost inventory method for the raw materials? Why?

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

M91
Number 4 (Estimated time — 15 to 25 minutes)

On December 31, 1989, Port Co. sold six-month old equipment at fair value and leased it back. There was a loss on the sale. Port pays all insurance, maintenance, and taxes on the equipment. The lease provides for eight equal annual payments, beginning December 31, 1990, with a present value equal to 85% of the equipment's fair value and sales price. The lease's term is equal to 80% of the equipment's useful life. There is no provision for Port to reacquire ownership of the equipment at the end of the lease term.

Required:

a. 1. Why is it important to compare an equipment's fair value to its lease payments' present value and its useful life to the lease term?
    2. Evaluate Port's leaseback of the equipment in terms of each of the four criteria for determination of a capital lease.

b. How should Port account for the sale portion of the sale-leaseback transaction at December 31, 1989?

c. How should Port report the leaseback portion of the sale-leaseback transaction on its December 31, 1990, balance sheet?

M90
Number 3 (Estimated time — 15 to 25 minutes)

On January 2, 1987, Drew Company issued 9% term bonds dated January 2, 1987, at an effective annual interest rate (yield) of 10%. Drew uses the effective interest method of amortization. On July 1, 1989, the bonds were extinguished early when Drew acquired them in the open market for a price greater than their face amount.

On September 1, 1989, Drew issued for cash 7% nonconvertible bonds dated September 1, 1989, with detachable stock purchase warrants. Immediately after issuance, both the bonds and the warrants had separately determined market values.

Required:

a. How should Chester report the threat of expropriation of assets? Why?
b. How should Chester report the potential costs due to the safety hazard? Why?

c. How should Chester report the noninsurable rock-slide risk? Why?

**M89**

**Number 4 (Estimated time — — 15 to 25 minutes)**

On January 2, 1988, Druid Company issued 9% term bonds dated January 2, 1988, at an effective interest rate (yield) of 10%. Druid uses the effective interest method of amortization.

On December 1, 1988, Druid issued 8% nonconvertible bonds dated December 1, 1988, with detachable stock purchase warrants. Immediately after issuance, both the bonds and the warrants have separately determined fair market values.

**Required:**

a. How would the issue price of the 9% bonds be determined?

b. 1. Were the 9% bonds issued at par, at a discount, or at a premium? Why?

   2. Using the effective interest method of amortization, would the amount of interest expense for the 9% bonds be higher in the first year or second year? Why?

c. How should Druid account for the proceeds from the issuance of the 8% nonconvertible bonds with detachable stock purchase warrants? Why?

**M89**

**Number 5 (Estimated time — — 15 to 25 minutes)**

On January 1, 1988, Von Company entered into two noncancellable leases for new machines to be used in its manufacturing operations. The first lease does not contain a bargain purchase option; the lease term is equal to 80 percent of the estimated economic life of the machine. The second lease contains a bargain purchase option; the lease term is equal to 50 percent of the estimated economic life of the machine.

**Required:**

a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? Do not discuss the specific criteria for classifying a lease as a capital lease.

b. How should a lessee account for a capital lease at its inception?

c. How should a lessee record each minimum lease payment for a capital lease?

d. How should Von classify each of the two leases? Why?

**M88**

**Number 4 (Estimated time — — 15 to 25 minutes)**

Skinner Company has the following contingencies:

- Potential costs due to the discovery of a possible defect related to one of its products. These costs are probable and can be reasonably estimated.
- A potential claim for damages to be received from a lawsuit filed this year against another company. It is probable that proceeds from the claim will be received by Skinner next year.
- Potential costs due to a promotion campaign whereby a cash refund is sent to customers when coupons are redeemed. Skinner estimated, based on past experience, that 70% percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed and the cash refunds sent this year. The remaining 30 percent of the coupons are expected to be redeemed next year.

**Required:**

a. How should Skinner report the potential costs due to the discovery of a possible product defect? Why?

b. How should Skinner report this year the potential claim for damages that may be received next year? Why?

c. This year, how should Skinner account for the potential costs and obligations due to the promotion campaign?

**M88**

**Number 4 (Estimated time — — 15 to 25 minutes)**

On January 1, 1987, Metcalf Company sold equipment for cash and leased it back. As seller-lessee, Metcalf retained the right to substantially all of the remaining use of the equipment.

The term of the lease is eight years. There is a gain on the sale portion of the transaction. The lease portion of the transaction is classified appropriately as a capital lease.

**Required:**

a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? Do not discuss the specific criteria for classifying a lease as a capital lease.

b. 1. How should Metcalf account for the sale portion of the sale-leaseback transaction at January 1, 1987?

   2. How should Metcalf account for the lease-back 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?
Selected Questions

N87
Number 4 (Estimated time — 15 to 25 minutes)

Spackenkill Company is a manufacturer of household appliances. During the year, the following information became available:

- Potential costs due to the discovery of a safety hazard related to one of its products — These costs are probable and can be reasonably estimated.
- Potential costs of new product warranty costs — These costs are probable but cannot be reasonably estimated.
- Potential costs due to the discovery of a possible product defect related to one of its products — These costs are reasonably possible and can be reasonably estimated.

Required:
  
a. How should Spackenkill report the potential costs due to the discovery of a safety hazard? Why?
  
b. How should Spackenkill report the potential costs of warranty costs? Why?
  
c. How should Spackenkill report the potential costs due to the discovery of a possible product defect? Why?

N87
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?

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M91
Number 5 (Estimated time — 15 to 25 minutes)

Jay Co.’s 1990 consolidated financial statements include two wholly owned subsidiaries, Jay Co. of Australia (Jay A) and Jay Co. of France (Jay F). Functional currencies are the US dollar for Jay A and the franc for Jay F.

Required:
  
a. What are the objectives of translating a foreign subsidiary’s financial statements?
  
b. How are gains and losses arising from translating or remeasuring of each subsidiary’s financial statements measured and reported in Jay’s consolidated financial statements?
  
c. FASB Statement No. 52 identifies several economic indicators that are to be considered both individually and collectively in determining the functional currency for a consolidated subsidiary. List three of those indicators.
  
d. What exchange rate is used to incorporate each subsidiary’s equipment cost, accumulated depreciation, and depreciation expense in Jay’s consolidated financial statements?

N90
Number 3 (Estimated time — 15 to 25 minutes)

At December 31, 1989, Roko Co. has two fixed price construction contracts in progress. Both contracts
have monthly billings supported by certified surveys of work completed. The contracts are:

- The Ski Park contract, begun in 1988, is 80% complete, is progressing according to bid estimates, and is expected to be profitable.

- The Nassau Village contract, a project to construct 100 condominium units, was begun in 1989. Thirty-five units have been completed. Work on the remaining units is delayed by conflicting recommendations on how to overcome unexpected subsoil problems. While the total cost of the project is uncertain, a loss is not anticipated.

**Required:**

a. Identify the alternatives available to account for long-term construction contracts, and specify the criteria used to determine which method is applicable to a given contract.

b. Identify the appropriate accounting method for each of Roko’s two contracts, and describe each contract’s effect on net income for 1989.

c. Indicate how the accounts related to the Ski Park contract should be reported on the balance sheet at December 31, 1989.

**M90**

**Number 5 (Estimated time — 15 to 25 minutes)**

Boulder Company appropriately changed its depreciation method for its production machinery from the double-declining balance method to the production method effective January 1, 1989.

In addition, effective January 1, 1989, Boulder appropriately changed the salvage values used in computing depreciation for its office equipment.

On December 31, 1989, Boulder appropriately changed the specific subsidiaries constituting the group of companies for which consolidated financial statements are presented.

**Required:**

a. Identify any accounting changes in the three situations described above. For each accounting change identified, indicate whether Boulder should show:

- The cumulative effect of a change in accounting principle in net income of the period of change.
- Pro forma effects of retroactive application for all prior periods presented currently.
- Restatement of the financial statements of all prior periods presented currently.

b. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one generally accepted accounting principle to another generally accepted accounting principle?

**N89**

**Number 4 (Estimated time — 15 to 25 minutes)**

Clonal, Inc., a biotechnology company, developed and patented a diagnostic product called Trouver. Clonal purchased some research equipment to be used exclusively for Trouver and other research equipment to be used on Trouver and subsequent research projects. Clonal defeated a legal challenge to its Trouver patent, and began production and marketing operations for the product.

Corporate headquarters’ costs were allocated to Clonal’s research division as a percentage of the division’s salaries.

**Required:**

a. How should the equipment purchased for Trouver be reported in Clonal’s income statements and balance sheets?

b. 1. Describe the matching principle.

2. Describe the accounting treatment of research and development costs and consider whether this is consistent with the matching principle. What is the justification for the accounting treatment of research and development costs?

c. How should corporate headquarters’ costs allocated to the research division be classified in Clonal’s income statement? Why?

d. How should the legal expenses incurred in defending Trouver’s patent be reported in Clonal’s statement of cash flows (direct method)?
Selected Questions

M89
Number 5 (Estimated time — — 15 to 25 minutes)

Hillside Company had a loss during the year ended December 31, 1988 that is properly reported as an extraordinary item.

On July 1, 1988, Hillside committed itself to a formal plan for sale of a business segment. A loss is expected from the proposed sale. Segment operating losses were incurred continuously throughout 1988, and were expected to continue until final disposition in 1989. Costs were incurred in 1988 to relocate segment employees.

Required:

a. How should Hillside report the extraordinary item in its income statement? Why?

b. How should Hillside report the effect of the discontinued operations in its 1988 income statement?

c. How should Hillside report the costs that were incurred to relocate employees of the discontinued segment? Why?

Do not discuss earnings per share requirements.

M88
Number 3 (Estimated time — — 15 to 25 minutes)

There are various types of accounting changes, each of which is required to be reported differently.

Required:

a. What type of accounting change is a change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets? Under what circumstances does this type of accounting change occur?

b. What type of accounting change is a change in the expected service life of an asset arising because of more experience with the asset? Under what circumstances does this type of accounting change occur?

c. With respect to a change in accounting principle:
   1. How should a company calculate the effect?
   2. How should a company report the effect?

Do not discuss earnings per share requirements.

d. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one accounting principle to another accounting principle?

M88
Number 5 (Estimated time — — 15 to 25 minutes)

Carson Company sponsors a single-employer defined benefit pension plan. The plan provides that pension benefits are determined by age, years of service, and compensation. Among the components that should be included in the net pension cost recognized for a period are service cost, interest cost, and actual return on plan assets.

Required:

a. What two accounting problems result from the nature of the defined benefit pension plan? Why do these problems arise?

b. How should Carson determine the service cost component of the net pension cost?

c. How should Carson determine the interest cost component of the net pension cost?

d. How should Carson determine the actual return on plan assets component of the net pension cost?

M87
Number 4 (Estimated time — — 15 to 25 minutes)

Lynn Company discontinued operations of a segment of its business in the middle of the year. The segment was operating at a loss from the beginning of the year. At the measurement date, a loss is expected from the proposed sale of the segment. This expected loss includes operating losses during the phase-out period which will extend into next year.

In addition, Lynn had one of its manufacturing plants destroyed by an earthquake during the year. The loss is properly reported as an extraordinary item.

Required:

a. How should Lynn report discontinued operations of a segment of its business on its income statement for this year? Do not discuss earnings per share requirements.

b. What are the criteria for classification as an extraordinary item?

c. How should Lynn report the extraordinary loss from the earthquake on its income statement for this year? Do not discuss earnings per share requirements.
Accounting Theory

VI. Other Financial Topics

M91
Number 2 (Estimated time — 15 to 25 minutes)

Pap Co. and Sib Co. plan to combine on December 31, 1990, with Sib becoming Pap’s subsidiary. Pap’s $1 par value common stock will be exchanged, on a 3 for 1 basis, for the majority of Sib’s outstanding $1 par value common stock. Johnson continues to hold a minority interest in Sib. There is neither treasury stock nor intercompany holdings. Both companies use the same accounting methods and practices, and have net assets with fair values in excess of carrying amounts. Ignore any expense connected with the combination.

Required:

a. What is the conceptual rationale used to account for a business combination as a pooling of interests? Do not discuss accounting entries or specific criteria required for applying pooling-of-interests accounting.

b. What percentage of Sib’s outstanding common stock must be exchanged at December 31, 1990, so that pooling-of-interests accounting is used for the combination?

c. If pooling-of-interests accounting is used, how should the December 31, 1990, consolidated balance sheet report:
   1. Assets and liabilities?
   2. Investors’ interests?

N88
Number 5 (Estimated time — 15 to 25 minutes)

There are two methods of accounting for business combinations, purchase and pooling of interests.

Required:

a. 1. What is the rationale for accounting for a business combination as a purchase? Do not discuss the specific criteria for accounting for a business combination as a purchase.
   2. In a business combination accounted for as a purchase, how should the amount of goodwill at acquisition be determined?
   3. In a business combination accounted for as a purchase, how should goodwill be amortized?

b. 1. What is the rationale for accounting for a business combination as a pooling of interests? Do not discuss the specific criteria for accounting for a business combination as a pooling of interests.
   2. In a business combination accounted for as a pooling of interests, when both companies use the same methods of accounting, how should the stockholders’ equity be accounted for?

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?
Selected Questions

2. In the business combination accounted for as a pooling of interests, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a pooling of interests, how should the results of operations for the year in which the business combination occurred be reported?

b. 1. In the business combination accounted for as a purchase, how should the assets acquired and liabilities assumed be recorded? What is the rationale for accounting for a business combination as a purchase?

2. In the business combination accounted for as a purchase, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a purchase, how should the results of operations of the acquired company for the year in which the business combination occurred be reported?
M91
Answer 3 (10 points)

a. 1. The specific identification method requires each unit to be clearly distinguished from similar units either by description, identification number, location, or other characteristic. Costs are accumulated for specific units and expensed as the units are sold. Thus, the specific identification method results in recognized cost flows being identical to actual physical flows. Ideally, each unit is relatively expensive and the number of such units relatively few so that recording of costs is not burdensome. Under the specific identification method, if similar items have different costs, cost of goods sold is influenced by the specific units sold.

2. It is appropriate for Happlia to use the specific identification method because each appliance is expensive, and easily identified by number and description. The specific identification method is feasible because Happlia already maintains records of its units held by individual retailers. Management's ability to manipulate cost of goods sold is minimized because once the inventory is in retailer's hands Happlia's management cannot influence the units selected for sales.

b. 1. Happlia should include in inventory carrying amounts all necessary and reasonable costs to get an appliance into a useful condition and place for sale. Common (or joint) costs should be allocated to individual units. Such costs exclude the excess costs incurred in transporting refrigerators to Minneapolis and their reshipment to Kansas City. These units costs should only include normal freight costs from Des Moines to Kansas City. In addition, costs incurred to provide time utility to the goods, i.e., ensuring that they are available when required, will also be included in inventory carrying amounts.

2. Examples of inventoriable costs include the unit invoice price, plus an allocated proportion of the port handling fees, import duties, freight costs to Des Moines and to retailers, insurance costs, repackaging, and warehousing costs.

c. The 1990 income statement should report in cost of goods sold all inventory costs related to units sold in 1990, regardless of when cash is received from retailers. Excess freight costs incurred for shipping the refrigerators from Minneapolis to Kansas City should be included in determining operating income.

M90
Answer 2 (10 points)

a. Under the cost method, the investor recognizes dividends as income when received. Under the equity method, an investor recognizes as income its share of an investee's earnings or losses in the periods in which they are reported by the investee. The amount recognized as income is adjusted for any change in the difference between investment cost and underlying equity in net assets at the investment date. The equity method is more consistent with accrual accounting than is the cost method, because the equity method recognizes income when earned rather than when dividends are received.

b. Monroe should have assessed whether it could have exerted significant influence over Grumer's operating and financial policies. Monroe did not own 20% or more of Grumer's voting stock (which would have given the refutable presumption that it could exercise significant influence); however, the ability to exercise significant influence may be indicated by other factors such as Monroe's provision of three key management personnel and purchase of 25% of Grumer's output.

c. On becoming a 30% owner of Grumer, Monroe should use the equity method to account for its investment. As of January 2, 1990, Monroe's investment and retained earnings accounts must be adjusted retroactively to show balances as if the equity method had been used from the initial purchase date. Both accounts should be increased by 18% of Grumer's undistributed income since formation. [In this case, no adjustment to the undistributed income is necessary since the stock was issued at its book value which was assumed to approximate its fair value.]

M90
Answer 2 (10 points)

a. To account for the accounts receivable factored on April 1, 1989, Magrath should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss equal to the difference. The loss should be reported in the income statement. Factoring of accounts receivable on a without recourse basis is equivalent to a sale.
b. The carrying amount of the note at July 1, 1989 is the maturity amount discounted for two years at the market interest rate. For the noninterest-bearing note receivable, the interest revenue for 1989 should be determined by multiplying the carrying amount of the note at July 1, 1989 times the market rate of interest at the date of the note times one-half.

The noninterest-bearing note receivable should be reported in the December 31, 1989 balance sheet, as a noncurrent asset at its face amount less the unamortized discount.

c. Magrath should account for the collection of the accounts previously written off as uncollectible as follows:

- Increase both accounts receivable and the allowance for uncollectible accounts.
- Increase cash and decrease accounts receivable.

d. One approach estimates uncollectible accounts based on credit sales. This approach focuses on income determination by attempting to match uncollectible accounts expense with the revenues generated.

The other allowance approach estimates uncollectible accounts based on the balance in or aging of receivables. The approach focuses on asset valuation by attempting to report receivables at realizable value.

M90
Answer 4 (10 points)

a. Purchases from various suppliers generally should be included in Huddell's inventory when Huddell receives the goods. Title to goods purchased FOB destination is assumed to pass when the goods are received.

b. Huddell should account for the warehousing costs as additional cost of inventory. All necessary and reasonable costs of readying goods for sale should be included in inventory.

c. 1. The advantages of using the dollar value LIFO method are to reduce the cost of accounting for inventory and to minimize the probability of reporting the liquidation of LIFO inventory layers.

2. The application of dollar value LIFO is based on dollars of inventory, an inventory cost index for each year, and broad inventory pools. The inventory layers are identified with the inventory cost index for the year in which the layer was added. In contrast, traditional LIFO is applied to individual units at their cost.

d. 1. Huddell's net markups should be included only in the retail amounts (denominator) to determine the cost to retail percentage.

Huddell's net markdowns should be ignored in the calculation of the cost to retail percentage.

2. By not deducting net markdowns from the retail amounts to determine the cost to retail percentage, Huddell produces a lower cost to retail percentage than would result if net markdowns were deducted. Applying this lower percentage to ending inventory at retail, the inventory is reported at an amount below cost. This amount is intended to approximate lower of average cost or market.

M89
Answer 2 (10 points)

a. Capital expenditures benefit future periods. Revenue expenditures benefit the current period only.

b. 1. The purchase price of the land should be capitalized. The land should be shown as a noncurrent asset on the balance sheet at its original cost and it is not subject to depreciation.

2. The cost of constructing the factory should be capitalized and depreciated over the expected life of the factory. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The factory expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

3. The cost of grading and paving the parking lot should be capitalized and depreciated over the expected life of either the factory or parking lot, whichever is shorter. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The land improvement expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

4. The cost of maintaining the factory once production has begun is a "revenue type" expenditure. However, since it is a factory cost, it should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

M89
Answer 2 (10 points)

a. The differences between the selling prices and the costs of securities sold should be reported as realized gains and losses in the determination of net income.

b. The security in the current portfolio should be reclassified to the noncurrent portfolio at the lower of its cost or market value at the date of reclassification. Since its market value was less than cost, the market value becomes the new cost basis. The excess of cost over
market value at the date of reclassification should be reported as a realized loss in the determination of net income.

c. Each portfolio should be reported in the balance sheet at its separately determined lower of aggregate cost or market value. Applying this rule, Vane would report each portfolio at market by using a valuation allowance (contra) account for the excess of aggregate cost over aggregate market value. For the current portfolio, the change in the valuation allowance (contra) account that occurred during the year should be reported as an unrealized gain or loss in the income statement. For the noncurrent portfolio, an amount equal to the valuation allowance (contra) account balance should be reported separately in the equity section of the balance sheet.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period and is consistent with conservatism. For the current portfolio, the estimated loss is reported (matched) in the income statement in the period in which the change in realizable value occurred. Reporting the current portfolio at market indicates the expected cash flow from the sale of the securities. Inclusion of the reduction in market value of the current portfolio in net income assists in cash flow projections by acknowledging the expected impairment in future cash flows as a consequence of the investment. For the noncurrent portfolio, the decline in market value (loss) is less certain of realization in the near term, and may not be a reasonable estimate of the cash flow consequence of the investment. Therefore, changes in market value of the noncurrent portfolio are not considered useful for cash flow projections.

N89
Answer 3 (10 points)

a. Inventory cost should include all reasonable and necessary costs of preparing inventory for sale. These costs include not only the purchase price of the inventories, but also other costs associated with readying inventories for sale.

b. The lower of cost or market rule produces a realistic estimate of future cash flows to be realized from the sale of inventories. This is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

c. Steel's inventories should be reported on the balance sheet at market. According to the lower of cost or market rule, market is defined as replacement cost. Market cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is between net realizable value and net realizable value less the normal profit margin. Therefore, market is established as replacement cost. Since market is less than original cost, inventory should be reported at market.

d. Ending inventories and net income would have been the same under either lower of average cost or market or lower of FIFO cost or market. In periods of declining prices, the lower of cost or market rule results in a write-down of inventory cost to market under both methods, resulting in the same inventory cost. Therefore, net income using either inventory method is the same.

N88
Answer 2 (10 points)

a. 1. Hogan should account for the sales discounts at the date of sale using the net method by recording accounts receivable and sales revenue at the amount of sales less the sales discounts available. Revenues should be recorded at the cash equivalent price at the date of sale. Under the net method, the sale is recorded at an amount that represents the cash equivalent price at the date of exchange (sale).

2. There is no effect on Hogan's sales revenues when customers do not take the sales discounts. Hogan's net income is increased by the amount of interest (discount) earned when customers do not take the sales discounts.

b. Trade discounts are neither recorded in the accounts nor reported in the financial statements. Therefore, the amount recorded as sales revenues and accounts receivable is net of trade discounts and represents the cash equivalent price of the asset sold.

c. To account for the accounts receivable factored on August 1, 1987, Hogan should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss. Factoring of accounts receivable on a without recourse basis is equivalent to a sale. The difference between the cash received and the carrying amount of the receivables is a loss.

d. Hogan should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period from October 1 through December 31 on its balance sheet as noncurrent assets. Both assets are due on September 30, 1989, which is more than one year from the date of the balance sheet. Hogan should report interest revenue from the notes receivable on its income statement for the year ended December 31, 1987. Interest revenue is equal to the amount accrued on the notes receivable at the appropriate rate for three months. Interest revenue is realized with the passage of time. Accordingly, interest revenue should be accounted for as an element of income over the life of the notes receivable.
Accounting Theory

N88
Answer 3 (10 points)

a. 1. The capitalized cost for the computer includes all costs reasonable and necessary to prepare it for its intended use. Examples of such costs are the cash purchase price, delivery, installation, testing, and set up.
   2. The objective of depreciation accounting is to allocate the depreciable cost of an asset over its estimated useful life in a systematic and rational manner. This process matches the depreciable cost of the asset with revenues generated from its use. Depreciable cost is the capitalized cost less its estimated residual (salvage) value.

b. The rationale for using accelerated depreciation methods is based on the following assumptions:
   • An asset is more productive in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.
   • An asset may become technologically obsolete prior to the end of its originally estimated useful life. The risk associated with estimated long-term cash flows is greater than the risk associated with near-term cash flows. Accelerated depreciation recognizes this condition.

c. Patrick should record depreciation expense to the date of disposal. Recording depreciation updates the carrying amount of the automobile. If the carrying amount of the automobile (capitalized cost less accumulated depreciation) differs from the cash proceeds from the disposal, a gain or loss results. Patrick should report gain or loss on disposal as part of income from continuing operations.

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.

M87
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.

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

M91
Answer 4 (10 points)

a. Comparisons of an equipment’s fair value to its lease payments’ present value, and of its useful life to the lease term, are used to determine whether the lease is equivalent to an installment sale, and therefore is a capital lease.

2. A lease is categorized as a capital lease, if, at the date of the lease agreement, it meets any one of four criteria. As the lease has no provision for Port to reacquire ownership of the equipment, it fails the two criteria of transfer of ownership at the end of the lease and a bargain purchase option. Port’s lease payments, with a present value equaling 85% of the equipment’s fair value, fail the criterion for a present value equaling or exceeding 90% of the equipment’s fair value. However, the lease would be classified as a capital lease, because its term of 80% of the equipment’s estimated useful life exceeds the criterion of being at least 75% of the equipment’s estimated useful life.

b. Port should account for the sale portion of the sale-leaseback transaction at December 31, 1989, by increasing cash for the sale price, decreasing equipment by the carrying amount, and recognizing a loss for the excess of the equipment’s carrying amount over its sale price.

c. On the December 31, 1990, balance sheet, the equipment should be included as a fixed asset, at the lease payments’ present value at December 31, 1989, less 1990 amortization.

On the December 31, 1990, balance sheet, the lease obligation will equal the lease payments’ present value at December 31, 1989, less principal repaid December 31, 1990. This amount will be reported in current liabilities for the principal to be repaid in 1991, and the balance in noncurrent liabilities.

M90
Answer 3 (10 points)

a. The 9% bonds were issued at a discount (less than face amount). Although the bonds provide for payment of interest of 9% of face amount, this rate was less than the prevailing or market rate for bonds of similar quality at the time the bonds were issued. Thus, the issue price of the bonds, which is the present value of the principal and interest payments discounted at 10%, is less than the face amount.

2. The amount of interest expense would be higher in the second year of the life of the bond issue than in the first year of the life of the bond issue. According to the effective interest method of amortization, the 10% effective interest rate is applied to the bond carrying amount. In a discount situation, the bond carrying amount increases each year, and this results in a greater interest expense in each successive year.

b. 1. Gain or loss on early extinguishment of debt should be determined by comparing the carrying amount of the bonds at the date of extinguishment with the acquisition price. If the carrying amount exceeds the acquisition price, a gain results. If the carrying amount is less than the acquisition price, a loss results.

In this case, a loss results. The term bonds were issued at a discount. Therefore, the carrying amount of the bonds at the date of extinguishment must be less than the face amount, which is less than the acquisition price.

2. Drew should report the loss from early extinguishment of debt in its 1989 income statement as an extraordinary item, net of income taxes.

c. The proceeds from the issuance of the 7% non-convertible bonds with detachable stock purchase warrants should be recorded as an increase in cash. These proceeds should be allocated between the bonds and the warrants on the basis of their relative market values. The portion of the proceeds allocable to the bonds should be accounted for as long-term debt, while the portion allocable to the warrants should be accounted for as paid-in capital.

N89
Answer 3 (10 points)

a. Chester should disclose the threat of expropriation of assets in the notes to the financial statements. Disclosure would include an estimate of the possible loss or an estimate of the range of loss. Accrual of a loss is inappropriate because the threat of expropriation is only reasonably possible.
b. Chester should report the potential costs due to the safety hazard by accruing a loss in the income statement and a liability in the balance sheet. Accrual is required because both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of the loss can be reasonably estimated.

In addition, Chester should separately disclose in the notes to the financial statements the nature of the safety hazard.

c. Chester should not accrue a loss because an asset has not been impaired nor has a liability been incurred. Disclosure of the uninsured rock-slide risk, while permitted, is not required.

**M89 Answer 4 (10 points)**

a. The issue price of the bond is determined by calculating the present value of all expected future cash outflows discounted at the effective interest rate (yield) of 10%. The issue price is the sum of the present value of the bonds' maturity amount (face value) plus the present value of the series of future interest payments.

b. 1. The 9% bonds were issued at a discount (less than face value). Although the bonds provide for the payment of interest at 9% of face value, 9% was less than the prevailing or market rate. Thus, in order to provide a yield of 10% to investors, the bonds must have been issued at a discount.

2. The amount of interest expense would be higher in the second year than in the first year. According to the effective interest method of amortization, the 10% effective interest rate is applied to an increasing bond carrying amount, which results in a higher interest expense in each successive year.

c. The proceeds from the issuance of the 8% nonconvertible bonds with detachable stock purchase warrants should be allocated between the bonds and the warrants on the basis of their relative fair market values. The portion of the proceeds allocable to the bonds should be accounted for as long-term debt, while the portion allocable to the warrants should be accounted for as paid-in capital.

**M89 Answer 5 (10 points)**

a. The economic effects of a long-term capital lease on the lessee are similar to that of an equipment purchase using installment debt. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee, and obligates the lessee in a manner similar to that created when funds are borrowed. To enhance comparability between a firm that purchases an asset on a long-term basis and a firm that leases an asset under substantially equivalent terms, the lease should be capitalized.

b. A lessee should account for a capital lease at its inception as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit thereon. However, if the present value exceeds the fair value of the leased property at the inception of the lease, the amount recorded for the asset and obligation should be the fair value.

c. A lessee should allocate each minimum lease payment between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.

d. Von should classify the first lease as a capital lease because the lease term is more than 75 percent of the estimated economic life of the machine. Von should classify the second lease as a capital lease because the lease contains a bargain purchase option.

**N88 Answer 4 (10 points)**

a. Skinner should report the potential costs due to the discovery of a possible product defect as an expense or loss in the income statement and as a liability in the balance sheet. In addition, Skinner should disclose the nature of the costs due to the discovery of a possible product defect.

Accrual and disclosure are required if both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In this case both conditions are met.

b. Skinner should not report the potential claim for damages that may be received next year in the current year's income statement or balance sheet. Gain contingencies usually are not recorded in the accounts in advance of their realization. However, adequate disclosure should be made of gain contingencies, but care should be exercised to avoid misleading implications as to the likelihood of realization.

c. This year, Skinner should account for the potential costs due to the promotion campaign as a premium expense and as a liability for 70 percent of the dollar amount of the coupons issued. The amount of the liability at the end of this year would be 30 percent of the dollar amount of the coupons issued. This amount represents 70 percent of the dollar amount of the coupons issued this year less 40 percent of the dollar amount of the coupons redeemed and for which cash refunds were sent.
Accounting Theory

M88
Answer 4 (10 points)

a. The economic effect of a long-term capital lease on the lessee is similar to that of an installment purchase. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee. Therefore, the lease should be capitalized.

b. 1. Metcalf should account for the sale portion of the sale-leaseback transaction at January 1, 1987, by recording cash for the sale price, decreasing equipment at the undepreciated cost (net carrying amount) of the equipment, and establishing a deferred gain on sale-leaseback for the excess of the sale price of the equipment over its undepreciated cost (net carrying amount).

   2. Metcalf should account for the leaseback portion of the sale-leaseback transaction at January 1, 1987, by recording both an asset and a liability at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit. However, if the present value exceeds the fair value of the leased equipment at January 1, 1987, the amount recorded for the asset and liability should be the equipment’s fair value.

c. The deferred gain should be amortized over the lease term or life of asset, whichever is appropriate. During the first year of the lease, the amortization will be an amount proportionate to the amortization of the asset. This deferral and amortization method for a sale-leaseback transaction is required because the sale and the leaseback are two components of a single transaction rather than two independent transactions. Because of this interdependence of the sale and leaseback portions of the transaction, the gain should be deferred and amortized over the lease term.

M87
Answer 5 (10 points)

a. 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 conver-
sion was a significant economic transaction. The con-
version 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.

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and
Periodicity, and Their Relationship to Generally Accepted Accounting Principles

N91
Answer 5 (10 points)

a. The objectives of translating a foreign subsidiary’s
financial statements are to:

• Provide information that is generally compatible
with the expected economic effects of a rate change
on a subsidiary’s cash flows and equity.

• Reflect the subsidiary’s financial results and rela-
tionships in single currency consolidated financial
statements, as measured in its functional currency
and in conformity with GAAP.

b. Applying different exchange rates to the various
financial statement accounts causes the restated state-
ments to be unbalanced. The amount required to bring
the restated statements into balance is termed the gain
or loss from the translation or remeasurement. The gain
or loss arising from remeasuring Jay A’s financial state-
ments is reported in the consolidated income statement.
The gain or loss arising from translating Jay F’s financial
statements is reported separately under stockholders’
equity in the balance sheet.

c. The functional currency is the foreign currency or
parent’s currency that most closely correlates with the
following economic indicators:

• Cash flow indicators

• Sales price indicators

• Sales market indicators

• Expense indicators

• Financing indicators

• Intercompany transactions and arrangement indica-
tors

d. All accounts relating to Jay A’s equipment are re-
measured by the exchange rate prevailing between the
US and Australian dollars at the time equipment was
purchased.

All accounts relating to Jay F’s equipment are
translated by the current exchange rates prevailing be-
tween the US dollar and French franc. For the equip-
ment cost and accumulated depreciation this is the
current exchange rate at December 31, 1990. Depre-
ciation expense is translated at the rate prevailing on
the date the depreciation expense was recognized or an
appropriate weighted average exchange rate for 1990.

N90
Answer 3 (10 points)

a. The two alternative accounting methods to account
for long-term construction contracts are the percentage-
of-completion method and the completed-contract
method. The percentage-of-completion method must
be used if both of the following conditions are met at
the statement date:

• Reasonable estimates of profitability at completion.

• Reliable measures of progress toward completion.

If one or both of these conditions are not met at
the statement date, the completed-contract method
must be used.

b. The Ski Park contract must be accounted for by
the percentage-of-completion method. Eighty percent
of the estimated total income on the contract should
be recognized as of December 31, 1989. Therefore, the
1989 income to be recognized will equal 80% of the
estimated total income less the income reported under
the contract in 1988.

The Nassu Village contract must be accounted for
by the completed-contract method. Therefore no in-
come or loss is recognized in 1989 under this contract.

c. The receivable on the Ski Park contract should be
reported as a current asset. If costs plus gross profit
date exceed billings, the difference should be reported
as a current asset. If billings exceed cost plus gross profit
to date, the difference should be reported as a current
liability.

N90
Answer 4 (10 points)

a. The costs of research equipment used exclusively
for Trouver would be reported as research and devel-
opment expenses in the period incurred.
The costs of research equipment used on both Trouver and future research projects would be capitalized and shown as equipment (less accumulated depreciation) on the balance sheet. An appropriate method of depreciation should be used. Depreciation on capitalized research equipment should be reported as a research and development expense.

b. 1. Matching refers to the process of expense recognition by associating costs with revenues on a cause and effect basis.

2. Research and development costs are usually expensed in the period incurred and may not be matched with revenues. This accounting treatment is justified by the high degree of uncertainty regarding the amount and timing of future benefits. A direct relationship between research and development costs and future revenues generally cannot be demonstrated.

c. Corporate headquarters' costs allocated to research and development would be classified as general and administrative expenses in the period incurred, because they are not clearly related to research and development activities.

d. On Clonal's statement of cash flows, the legal expenses incurred in defending the patent should be reported under investing activities in the period paid.

**M90**

**Answer 5 (10 points)**

a. Boulder's change in depreciation method is a change in accounting principle. This change in accounting principle should show the cumulative effect of a change in accounting principle in net income of the period of change, and the pro forma effects of retroactive application for all prior periods presented currently. Financial statements of prior periods should not be restated.

Boulder's change in salvage values is a change in accounting estimate. Boulder would not report a cumulative effect, nor pro forma effects, nor would prior period financial statements be restated.

Boulder's change in the specific subsidiaries constituting the group of companies for which consolidated financial statements are presented is a change in reporting entity. Neither the cumulative effect nor the pro forma effects of the change should be reported. However, financial statements of prior periods presented currently should be restated.

b. 1. Consistent use of accounting principles from one accounting period to another enhances the comparability of accounting information across accounting periods, and thus increases the usefulness of financial statements.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. Disclosure is required because there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

**N89**

**Answer 4 (10 points)**

a. The interest cost component of the net pension cost for a period is the increase in the projected benefit obligation due to the passage of time. Essex would determine its interest cost component by applying an assumed discount rate to the beginning projected benefit obligation.

b. Prior service cost is the cost of retroactive benefits (increased benefits based on services rendered in prior periods) granted at the date of adoption or amendment of a pension plan. Prior service cost should be included in net pension cost during the future service periods of those employees active at the date of the pension plan adoption or amendment, as appropriate, who are expected to receive benefits under the pension plan. Prior service cost is incurred with the expectation that the employer will realize economic benefits in future periods.

c. Essex must accrue compensation for future vacations if all of the following conditions are met:

- Essex's obligation relating to employees' rights to receive compensation for future vacations is attributable to employees' services already rendered.
- The obligation relates to rights that vest or accumulate.
- Payment of the vacation benefits is probable.
- The amount can be reasonably estimated.

The theoretical rationale is that accruing compensation matches the cost of vacation benefits to the period in which services are rendered, and results in recognition of a measurable liability.

**N89**

**Answer 5 (10 points)**

a. Hillside should report the extraordinary item separately, net of applicable income taxes, below the continuing operations section in the income statement. Exclusion of extraordinary items from the results of continuing operations is intended to produce a measure of income from continuing operations that is useful in projecting future operating cash flows.

b. Hillside should report the discontinued operations separately in the 1988 income statement immediately below income from continuing operations. Discontinued operations should be comprised of two categories, with each category reported net of income taxes:

- Loss from operations of the discontinued segment from the beginning of the year to the measurement date.
Unofficial Answers

- Loss on disposal of the discontinued segment, including the provision for operating losses during the phase-out period.

- Hillside should include the costs incurred to relocate employees in the loss on disposal of the discontinued segment in its 1988 income statement. These costs are a direct result of the commitment to dispose of its segment.

M88

Answer 3 (10 points)

a. A change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets is a change in accounting principle. Both the sum-of-the-years'-digits method and the straight-line method are generally accepted. A change in accounting principle results from adoption of a generally accepted accounting principle different from the generally accepted accounting principle used previously for reporting purposes.

b. A change in the expected service life of an asset arising because of more experience with the asset is a change in accounting estimate. A change in accounting estimate occurs because future events and their effects cannot be perceived with certainty. Estimates are an inherent part of the accounting process. Therefore, accounting and reporting for certain financial statement elements requires the exercise of judgment, subject to revision based on experience.

c. 1. The cumulative effect of a change in accounting principle is the difference between (1) the amount of retained earnings at the beginning of the period of change and (2) the amount of retained earnings that would have been reported at that date if the new accounting principle had been used in prior periods.

2. The cumulative effect, net of income taxes, should be shown as a separate item in the income statement for the period of change between the captions "extraordinary items" and "net income". Pro-forma disclosure of the effects of retroactive restatement should be shown on the face of the income statement.

d. 1. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users of comparative accounting data.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

M88

Answer 5 (10 points)

a. The two accounting problems resulting from the nature of the defined benefit pension plan are as follows:

b. Estimates or assumptions must be made concerning the future events that will determine the amount and timing of the benefit payments.

- Some approach to attributing the cost of pension benefits to individual years of service must be selected.

The two problems arise because a company must recognize pension costs before it pays pension benefits.

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.
Accounting Theory

VI. Other Financial Topics

M91
Answer 2 (10 points)

a. A business combination accounted for as a pooling-of-interests is a continuation of ownership interests of previously separate companies. Each stockholder group retains risk and benefit elements from its former investments to which are added risks and benefits obtained through mutual exchanges with the other group or groups. Total resources of the pooled entity remain intact.

b. At least 90% of Sib's outstanding common stock must be exchanged on December 31, 1990, for the combination to be treated as a pooling-of-interests.

c. 1. The December 31, 1990, consolidated balance sheet reports assets and liabilities at the sum of Pap's and Sib's carrying amounts before the combination.
   2. Johnson's proportional ownership in Sib is reported as a minority interest regardless of the type of combination accounting. In pooling-of-interests accounting, to report the controlling stockholders' equity, the balance of Sib's stockholders' equity is added to Pap's stockholders' equity before the combination, with components as follows:
      - Common stock equals the par value of Pap's common stock outstanding after the combination.
      - Additional paid-in capital equals the sum of the two companies' additional paid-in capital before the combination less:
        - Johnson's proportional interest in Sib's additional paid-in capital, and
        - Excess of the par value of new Pap stock issued over par value of Sib stock exchanged.

If a negative amount arises from this calculation it is deducted from combined retained earnings.

- Retained earnings equals the sum of the separate retained earnings before the combination less
  - Johnson's proportional interest in Sib's retained earnings, and
  - Any deduction, as noted above, required for the issue of Pap's common stock.

N88
Answer 5 (10 points)

a. The number of shares that an individual is entitled to receive, and

b. The option or purchase price.

c. When options are forfeited, compensation expense, contributed capital-stock options, and deferred compensation (if used) are all decreased. This is necessary because the total compensation expense is less than that estimated in 1987.

d. Cash was increased by the stock option price [90% of the quoted market price on January 2, 1987] multiplied by the number of shares issued. Retained earnings was reduced by the compensation expense recorded in 1987 and 1988. Contributed capital was increased by the balancing amount for the above entries.

N90
Answer 5 (10 points)

a. Gunpowder's stock option measurement date is January 2, 1987. The stock option measurement date is the first date on which the employer knows both:

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.

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 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.
Auditing

Selected Questions
And Unofficial Answers
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* 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 Code of Professional Conduct

M91#52. The concept of materiality would be least important to an auditor when considering the
a. Adequacy of disclosure of a client’s illegal act.
b. Discovery of weaknesses in a client’s internal control structure.
c. Effects of a direct financial interest in the client on the CPA’s independence.
d. Decision whether to use positive or negative confirmations of accounts receivable.

M91#57. A violation of the profession’s ethical standards most likely would have occurred when a CPA
a. Compiled the financial statements of a client that employed the CPA’s spouse as a bookkeeper.
b. Received a fee for referring audit clients to a company that sells limited partnership interests.
c. Purchased the portion of an insurance company that performs actuarial services for employee benefit plans.
d. Arranged with a financial institution to collect notes issued by a client in payment of fees due.

M90#46. The first general standard requires that an audit of financial statements is to be performed by a person or persons having
a. Seasoned judgment in varying degrees of supervision and review.
b. Adequate technical training and proficiency.
c. Knowledge of the standards of field work and reporting.
d. Independence with respect to the financial statements and supplementary disclosures.

M90#47. The exercise of due professional care requires that an auditor
a. Examine all available corroborating evidence.
b. Critically review the judgment exercised at every level of supervision.
c. Reduce control risk below the maximum.
d. Attain the proper balance of professional experience and formal education.

M90#48. A CPA in public practice must be independent in fact and appearance when providing which of the following services?

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<td>No</td>
<td>No</td>
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<td>c. No</td>
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<td>d. No</td>
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M90#49. The third general standard states that due care is to be exercised in the performance of an audit. This standard is generally interpreted to require
a. Objective review of the adequacy of the technical training and proficiency of firm personnel.
b. Critical review of work done at every level of supervision.
c. Thorough review of the existing internal control structure.
d. Periodic review of a CPA firm’s quality control procedures.
The profession's ethical standards would most likely be considered to have been violated when a CPA

a. Continued an audit engagement after the commencement of litigation against the CPA alleging excessive fees filed in a stockholders' derivative action.
b. Represented to a potential client that the CPA's fees were substantially lower than the fees charged by other CPAs for comparable services.
c. Issued a report on a financial forecast that omitted a caution regarding achievability.
d. Accepted an MAS consultation engagement concerning data processing services for which the CPA lacked independence.

If requested to perform a review engagement for a nonmaterial direct financial interest, the accountant is

a. Independent because the financial interest is immaterial and, therefore, may issue a review report.
b. Not independent and, therefore, may not be associated with the financial statements.
c. Not independent and, therefore, may not issue a review report.
d. Not independent and, therefore, may issue a review report, but may not issue an auditor's opinion.

Which of the following bodies promulgates standards for audits of federal financial assistance recipients?

a. Governmental Accounting Standards Board.
b. Financial Accounting Standards Board.
c. General Accounting Office.
d. Governmental Auditing Standards Board.

According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?

a. The auditor's checking account, which is fully insured by a federal agency, is held at a client financial institution.
b. The auditor is also an attorney who advises the client as its general counsel.
c. An employee of the auditor donates service as treasurer of a charitable organization that is a client.
d. The client owes the auditor fees for two consecutive annual audits.

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.

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.

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.

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.

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.
Selected Questions

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#17. Audits of certain governmental entities are required to be performed in accordance with generally accepted government auditing standards (GAGAS). These standards do not require, as part of an auditor's report, the identification of
   a. Significant internal accounting and administrative controls designed to provide reasonable assurance that federal programs are being administered in compliance with applicable laws and regulations.
   b. Material weaknesses discovered as a result of the study and evaluation of the internal control systems.
   c. Sampling methods used to test the internal controls designed to detect errors and irregularities.
   d. Significant internal accounting and administrative controls that were not evaluated, and the reasons why they were not evaluated.

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.

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.

B. Control of the Audit

N90#36. A CPA firm evaluates its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to which of the following prescribed standards
   a. Quality control.
   b. Human resources.
   c. Supervision and review.
   d. Professional development.
M90#3. Analytical procedures used in planning an audit should focus on identifying
   a. Material weaknesses in the internal control structure.
   b. The predictability of financial data from individual transactions.
   c. The various assertions that are embodied in the financial statements.
   d. Areas that may represent specific risks relevant to the audit.

M90#50. In planning a new engagement, which of the following is not a factor that affects the auditor’s judgment as to the quantity, type, and content of working papers?
   a. The type of report to be issued by the auditor.
   b. The content of the client’s representation letter.
   c. The auditor’s estimated occurrence rate of attributes.
   d. The auditor’s preliminary evaluations of risk based on discussions with the client.

M90#51. When planning a sample for a substantive test of details, an auditor should consider tolerable misstatement for the sample. This consideration should
   a. Be related to the auditor’s business risk.
   b. Not be adjusted for qualitative factors.
   c. Be related to preliminary judgments about materiality levels.
   d. Not be changed during the audit process.

M90#52. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
   a. Timing of inventory observation procedures to be performed.
   b. Evidence to be gathered to provide a sufficient basis for the auditor’s opinion.
   c. Procedures to be undertaken to discover litigation, claims, and assessments.
   d. Pending legal matters to be included in the inquiry of the client’s attorney.

M90#53. The scope and nature of an auditor’s contractual obligation to a client ordinarily is set forth in the
   b. Scope paragraph of the auditor’s report.
   c. Engagement letter.
   d. Introductory paragraph of the auditor’s report.

M90#54. Which of the following are elements of a CPA firm’s quality control that should be considered in establishing its quality control policies and procedures?

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**Advancement Inspection Consultation**

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M89#4. A CPA firm’s quality control procedures pertaining to the acceptance of a prospective audit client would most likely include
   a. Inquiry of management as to whether disagreements between the predecessor auditor and the prospective client were resolved satisfactorily.
   b. Consideration of whether sufficient competent evidential matter may be obtained to afford a reasonable basis for an opinion.
   c. Inquiry of third parties, such as the prospective client’s bankers and attorneys, about information regarding the prospective client and its management.
   d. Consideration of whether the internal control structure is sufficiently effective to permit a reduction in the extent of required substantive tests.

M89#5. Which of the following audit risk components may be assessed in nonquantitative terms?

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<tr>
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<th>Inherent risk</th>
<th>Control risk</th>
<th>Detection risk</th>
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N88#6. Which of the following procedures would an auditor most likely include in the initial planning of an examination of financial statements?
   a. Discussing the examination with firm personnel responsible for non-audit services to the client.
   b. Inquiring of the client’s attorney as to any claims probable of assertion.
   c. Obtaining a written representation letter from management of the client.
   d. Determining whether necessary internal accounting control procedures are being applied as prescribed.

N88#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.
Selected Questions

N88#11. A CPA firm should establish procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets the firm's standards of quality. To achieve this goal, the firm most likely would establish procedures for
   a. Evaluating prospective and continuing client relationships.
   b. Reviewing engagement working papers and reports.
   c. Requiring personnel to adhere to the applicable independence rules.
   d. Maintaining personnel files containing documentation related to the evaluation of personnel.

N88#23. An auditor's document includes the following statement:

   "Our audit is subject to the risk that errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention."

The above passage is most likely from
   a. The explanatory paragraph of a "subject to" qualified auditor's report.
   b. An engagement letter.
   c. The explanatory paragraph of a compliance report on a governmental entity subject to GAO standards.
   d. A comfort letter.

N88#33. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
   a. Compliance with generally accepted reporting standards.
   b. A system of quality control.
   c. A system of peer review.
   d. Continuing professional education.

N88#54. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's
   a. Awareness of the consistency in the application of generally accepted accounting principles between periods.
   b. Evaluation of all matters of continuing accounting significance.
   c. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
   d. Understanding as to the reasons for the change of auditors.

M88#55. When planning an examination, an auditor should
   a. Consider whether the extent of substantive tests may be reduced based on the results of the internal control questionnaire.
   b. Make preliminary judgments about materiality levels for audit purposes.
   c. Conclude whether changes in compliance with prescribed control procedures justifies reliance on them.
   d. Prepare a preliminary draft of the management representation letter.

M88#56. A difference of opinion regarding the results of a sample can not be resolved between the assistant who performed the auditing procedures and the in-charge auditor. The assistant should
   a. Refuse to perform any further work on the engagement.
   b. Accept the judgment of the more experienced in-charge auditor.
   c. Document the disagreement and ask to be disassociated from the resolution of the matter.
   d. Notify the client that a serious audit problem exists.

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
   a. Audit risk.
   b. Inherent risk.
   c. Control risk.
   d. Detection risk.

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.
M87#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.

c. Management places little emphasis on meeting earnings projections.
d. Operating and financing decisions are dominated by several persons.

M90#48. On completing an audit, Larkin, CPA, was asked by the client to provide technical assistance in the implementation of a new EDP system. The set of pronouncements designed to guide Larkin in this engagement is the Statements on
a. Auditing Standards.
b. Standards for Management Advisory Services.
c. Quality Control Standards.
d. Standards for Accountants’ EDP Services.

M90#49. Which of the following is the authoritative body designated to promulgate attestation standards?
  a. Auditing Standards Board.
  b. Governmental Accounting Standards Board.
  c. Financial Accounting Standards Board.
  d. General Accounting Office.

M90#55. Disclosure of irregularities to parties other than a client’s senior management and its audit committee or board of directors ordinarily is not part of an auditor’s responsibility. However, to which of the following outside parties may a duty to disclose irregularities exist?

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<thead>
<tr>
<th>To the SEC when the client reports an auditor change</th>
<th>To a successor auditor when the successor makes appropriate inquiries</th>
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M90#56. Which of the following statements best describes an auditor’s responsibility to detect errors and irregularities?
  a. The auditor should study and evaluate the client’s internal control structure, and design the audit to provide reasonable assurance of detecting all errors and irregularities.
  b. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain material misstatements, and determine whether the necessary internal control procedures are prescribed and are being followed satisfactorily.
  c. The auditor should consider the types of errors and irregularities that could occur, and

C. Other Responsibilities

M91#51. Which of the following professional services would be considered an attest engagement?
  a. A management consulting engagement to provide EDP advice to a client.
  b. An engagement to report on compliance with statutory requirements.
  c. An income tax engagement to prepare federal and state tax returns.
  d. The compilation of financial statements from a client’s accounting records.

M91#56. When a CPA prepares a client’s federal income tax return, the CPA has the responsibility to
  a. Take a position of independent neutrality.
  b. Argue the position of the Internal Revenue Service.
  c. Be an advocate for the entity’s realistically sustainable position.
  d. Verify the data to be used in preparing the return.

M91#58. Blue Co., a privately held entity, asked its tax accountant, Cook, a CPA in public practice, to reproduce Blue’s internally prepared interim financial statements on Cook’s microcomputer when Cook prepared Blue’s quarterly tax return. Cook should not submit these financial statements to Blue unless, as a minimum, Cook complies with the provisions of
  a. Statements on Responsibilities in Tax Practice.
  b. Statements on Standards for Accounting and Review Services.
  c. Statements on Responsibilities in Unaudited Financial Services.
  d. Statements on Standards for Attestation Engagements.

M90#38. Which of the following circumstances is most likely to cause an auditor to consider whether a material misstatement exists?
  a. Transactions selected for testing are not supported by proper documentation.
  b. The turnover of senior accounting personnel is exceptionally low.

M90#52. To the SEC, a successor auditor, or a government funding agency, which of the following statements best describes the auditor’s responsibility?

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  a. The auditor should study and evaluate the client’s internal control structure, and design the audit to provide reasonable assurance of detecting all errors and irregularities.
  b. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain material misstatements, and determine whether the necessary internal control procedures are prescribed and are being followed satisfactorily.
  c. The auditor should consider the types of errors and irregularities that could occur, and
determine whether the necessary internal control procedures are prescribed and are being followed.

d. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain material misstatements, and design the audit to provide reasonable assurance of detecting material errors and irregularities.

M90#57. Morris, CPA, suspects that a pervasive scheme of illegal bribes exists throughout the operations of Worldwide Import–Export, Inc., a new audit client. Morris notified the audit committee and Worldwide's legal counsel, but neither could assist Morris in determining whether the amounts involved were material to the financial statements or whether senior management was involved in the scheme. Under these circumstances, Morris should

a. Express an unqualified opinion with a separate explanatory paragraph.
b. Disclaim an opinion on the financial statements.
c. Express an adverse opinion on the financial statements.
d. Issue a special report regarding the illegal bribes.

M90#58. Which of the following statements concerning illegal acts by clients is correct?

a. An auditor's responsibility to detect illegal acts that have a direct and material effect on the financial statements is the same as that for errors and irregularities.
b. An audit in accordance with generally accepted auditing standards normally includes audit procedures specifically designed to detect illegal acts that have an indirect but material effect on the financial statements.
c. An auditor considers illegal acts from the perspective of the reliability of management's representations rather than their relation to audit objectives derived from financial statement assertions.
d. An auditor has no responsibility to detect illegal acts by clients that have an indirect effect on the financial statements.

M90#59. If compiled financial statements presented in conformity with the cash receipts and disbursements basis of accounting do not disclose the basis of accounting used, the accountant should

a. Recompile the financial statements using generally accepted accounting principles.
b. Disclose the basis in the notes to the financial statements.
c. Clearly label each page “Unaudited.”
d. Disclose the basis of accounting in the accountant's report.

N89#59. Which of the following factors is most important concerning an auditor’s responsibility to detect errors and irregularities?

a. The susceptibility of the accounting records to intentional manipulations, alterations, and the misapplication of accounting principles.
b. The probability that unreasonable accounting estimates result from unintentional bias or intentional attempts to misstate the financial statements.
c. The possibility that management fraud, defalcations, and the misappropriation of assets may indicate the existence of illegal acts.
d. The risk that mistakes, falsifications, and omissions may cause the financial statements to contain material misstatements.

N89#60. If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next

a. Apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.
b. Seek the advice of an informed expert qualified to practice law as to possible contingent liabilities.
c. Report the matter to an appropriate level of management at least one level above those involved.
d. Discuss the evidence with the client's audit committee, or others with equivalent authority and responsibility.

N88#9. Which of the following circumstances would most likely cause an auditor to suspect that material irregularities exist in a client's financial statements?

a. Property and equipment are usually sold at a loss before being fully depreciated.
b. Significantly fewer responses to confirmation requests are received than expected.
c. Monthly bank reconciliations usually include several in-transit items.
d. Clerical errors are listed on an EDP-generated exception report.

N88#10. An auditor’s tests of the pricing of a client's inventory indicates the existence of many errors. However, because of inadequate records the auditor is uncertain about whether these errors materially affect the financial statements taken as a whole. The auditor may reasonably issue a (an)

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N88#12. An auditor of a manufacturer would most likely question whether that client has committed illegal acts if the client has
a. Been forced to discontinue operations in a foreign country.
b. Been an annual donor to a local political candidate.
c. Failed to correct material weaknesses in internal accounting control that were reported after the prior year's audit.
d. Disclosed several subsequent events involving foreign operations in the notes to the financial statements.

N88#15. Which of the following standards applies to management advisory services engagements?
a. In all matters relating to the assignment, an independence in mental attitude is to be maintained.
b. There is to be a proper study and evaluation of the existing internal accounting control as a basis for reliance thereon.
c. The work is to be adequately planned and assistants are to be properly supervised.
d. Informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the report.

N88#30. An accountant should not submit unaudited financial statements to the management of a nonpublic company unless, at a minimum, the accountant
a. Assists in adjusting the books of account and prepares the trial balance.
b. Types or reproduces the financial statements on plain paper.
c. Complies with the standards applicable to compilation engagements.
d. Applies analytical procedures to the financial statements.

N88#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.

N88#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.

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#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.
Selected Questions

c. Either a disclaimer of opinion or a qualified opinion.
d. Either an adverse opinion or a disclaimer of opinion.

M91#21. Evidential matter concerning proper segregation of duties ordinarily is best obtained by
a. Preparation of a flowchart of duties performed by available personnel.
b. Inquiring whether control procedures operated consistently throughout the period.
c. Reviewing job descriptions prepared by the personnel department.
d. Direct personal observation of the employees who apply control procedures.

M91#22. An auditor assesses control risk because it
a. Indicates where inherent risk may be the greatest.
b. Affects the level of detection risk the auditor may accept.
c. Determines whether sampling risk is sufficiently low.
d. Includes the aspects of nonsampling risk that are controllable.

M91#23. When considering the objectivity of internal auditors, an independent auditor should
a. Test a sample of the transactions and balances that the internal auditors examined.
b. Determine the organizational level to which the internal auditors report.
c. Evaluate the quality control program in effect for the internal auditors.
d. Examine documentary evidence of the work performed by the internal auditors.

M90#41. The objective of tests of details of transactions performed as tests of controls is to
a. Detect material misstatements in the account balances of the financial statements.
b. Evaluate whether an internal control structure policy or procedure operated effectively.
c. Determine the nature, timing, and extent of substantive tests for financial statement assertions.
d. Reduce control risk, inherent risk, and detection risk to an acceptably low level.

M90#42. An auditor uses the knowledge provided by the understanding of the internal control structure and the final assessed level of control risk primarily to determine the nature, timing, and extent of the
a. Attribute tests.
b. Compliance tests.
c. Tests of controls.
d. Substantive tests.

M90#26. Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?

A. Internal Control

A. Definitions and Basic Concepts

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b. Compliance tests.
c. Tests of controls.
d. Substantive tests.

M90#26. Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?

a. It is usually more difficult to detect transposition errors.
b. Transactions are usually authorized before they are executed and recorded.
c. It is usually easier for unauthorized persons to access and alter the files.
d. Random error associated with processing similar transactions in different ways is usually greater.

M90#27. Which of the following computer documentation would an auditor most likely utilize in obtaining an understanding of the internal control structure?

a. Systems flowcharts.
b. Record counts.
c. Program listings.
d. Record layouts.

M90#28. Miller Retailing, Inc. maintains a staff of three fulltime internal auditors who report directly to the controller. In planning to use the internal auditors to provide assistance in performing the audit, the independent auditor most likely will
a. Place limited reliance on the work performed by the internal auditors.
b. Decrease the extent of the tests of controls needed to support the assessed level of detection risk.
c. Increase the extent of the procedures needed to reduce control risk to an acceptable level.
d. Avoid using the work performed by the internal auditors.
Auditing

N89#36. An auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk primarily to
a. Determine whether procedures and records concerning the safeguarding of assets are reliable.
b. Ascertain whether the opportunities to allow any person to both perpetrate and conceal irregularities are minimized.
c. Modify the initial assessments of inherent risk and preliminary judgments about materiality levels.
d. Determine the nature, timing, and extent of substantive tests for financial statement assertions.

N89#37. An auditor's flowchart of a client's accounting system is a diagrammatic representation that depicts the auditor's
a. Program for tests of controls.
b. Understanding of the system.
c. Understanding of the types of irregularities that are probable, given the present system.
d. Documentation of the study and evaluation of the system.

N89#38. Computer systems are typically supported by a variety of utility software packages that are important to an auditor because they
a. May enable unauthorized changes to data files if not properly controlled.
b. Are very versatile programs that can be used on hardware of many manufacturers.
c. May be significant components of a client's application programs.
d. Are written specifically to enable auditors to extract and sort data.

N89#6. The development of constructive suggestions to a client for improvements in its internal control structure is
a. Addressed by the auditor only during a special engagement.
b. As important as establishing a basis for reliance on the internal control structure.
c. A requirement of the auditor's consideration of the internal control structure.
d. A desirable by-product of an audit engagement.

N89#7. Which of the following statements best describes how a detailed audit program of a CPA who is engaged to audit the financial statements of a large publicly held company compares with the audit client's comprehensive internal audit program?
   a. The comprehensive internal audit program is substantially identical to the audit program used by the CPA because both cover substantially identical areas.
   b. The comprehensive internal audit program is less detailed and covers fewer areas than would normally be covered by the CPA.
   c. The comprehensive internal audit program is more detailed and covers areas that would normally not be covered by the CPA.
   d. The comprehensive internal audit program is more detailed although it covers fewer areas than would normally be covered by the CPA.

N88#31. In evaluating internal accounting control, the auditor is basically concerned that the system provides reasonable assurance that
a. Operational efficiency has been achieved in accordance with management plans.
b. Errors and irregularities have been prevented or detected.
c. Controls have not been circumvented by collusion.
d. Management can not override the system.

N88#32. Proper segregation of functional responsibilities in an effective system of internal accounting control calls for separation of the functions of
a. Authorization, execution, and payment.
b. Authorization, recording, and custody.
c. Custody, execution, and reporting.
d. Authorization, payment, and recording.

N88#36. Which of the following characteristics distinguishes computer processing from manual processing?
   a. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.
   b. Errors or irregularities in computer processing will be detected soon after their occurrences.
   c. The potential for systematic error is ordinarily greater in manual processing than in computerized processing.
   d. Most computer systems are designed so that transaction trails useful for audit purposes do not exist.

N87#42. The use of fidelity bonds may indemnify a company from embezzlement losses. The use also
a. Reduces the company's need to obtain expensive business interruption insurance.
b. Protects employees who made unintentional errors from possible monetary damages resulting from such errors.
c. Allows the company to substitute the fidelity bonds for various parts of internal accounting control.
d. Reduces the possibility of employing persons with dubious records in positions of trust.

N87#2. When considering internal control, an auditor should be aware of the concept of reasonable assurance, which recognizes that the
   a. Segregation of incompatible functions is necessary to ascertain that internal control is effective.
b. Employment of competent personnel provides assurance that the objectives of internal control will be achieved.

c. Establishment and maintenance of a system of internal control is an important responsibility of the management and not of the auditor.

d. Cost of internal control should not exceed the benefits expected to be derived from internal control.

B. Consideration of the Internal Control Structure

M91#24. In an audit of financial statements in accordance with generally accepted auditing standards, an auditor is required to

a. Identify specific internal control structure procedures relevant to management’s financial statement assertions.

b. Perform tests of controls to evaluate the effectiveness of the entity’s accounting system.

c. Determine whether procedures are suitably designed to prevent or detect material misstatements.

d. Document the auditor’s understanding of the entity’s internal control structure.

M91#25. Which of the following factors are included in an entity’s control environment?

<table>
<thead>
<tr>
<th>Audit committee</th>
<th>Internal audit function</th>
<th>Organizational structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
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<td>No</td>
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<tr>
<td>b. Yes</td>
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<td>c. No</td>
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<td>Yes</td>
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<tr>
<td>d. Yes</td>
<td>Yes</td>
<td>Yes</td>
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</tbody>
</table>

M91#26. The acceptable level of detection risk is inversely related to the

a. Assurance provided by substantive tests.

b. Risk of misapplying auditing procedures.

c. Preliminary judgment about materiality levels.

d. Risk of failing to discover material misstatements.

M91#27. An auditor may decide to assess control risk at the maximum level for certain assertions because the auditor believes

a. Sufficient evidential matter to support the assertions is likely to be available.

b. Evaluating the effectiveness of policies and procedures is inefficient.

c. More emphasis on tests of controls than substantive tests is warranted.

d. Considering the relationship of assertions to specific account balances is more efficient.

M90#43. An auditor’s primary consideration regarding an entity’s internal control structure policies and procedures is whether they

a. Prevent management override.

b. Relate to the control environment.

c. Reflect management’s philosophy and operating style.

d. Affect the financial statement assertions.

M90#44. In planning an audit of certain accounts, an auditor may conclude that specific procedures used to obtain an understanding of an entity’s internal control structure need not be included because of the auditor’s judgments about materiality and assessments of

a. Control risk.

b. Detection risk.

c. Sampling risk.

d. Inherent risk.

M90#45. To obtain evidential matter about control risk, an auditor ordinarily selects tests from a variety of techniques, including

a. Analysis.

b. Confirmation.

c. Reperformance.

d. Comparison.

M90#46. During consideration of the internal control structure in a financial statement audit, an auditor is not obligated to

a. Search for significant deficiencies in the operation of the internal control structure.

b. Understand the internal control environment and the accounting system.

c. Determine whether the control procedures relevant to audit planning have been placed in operation.

d. Perform procedures to understand the design of the internal control structure policies.

M90#47. When control risk is assessed at the maximum level for all financial statement assertions, an auditor should document the auditor’s

<table>
<thead>
<tr>
<th>Understanding of the entity's internal control structure elements</th>
<th>Conclusion that control risk is at the maximum level</th>
<th>Basis for concluding that control risk is at the maximum level</th>
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<tbody>
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<tr>
<td>d. Yes</td>
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<td>Yes</td>
</tr>
</tbody>
</table>

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Auditing

M90#29. Which of the following elements of an entity's internal control structure includes the development of personnel manuals documenting employee promotion and training policies?
   a. Control procedures.
   b. Control environment.
   c. Accounting system.
   d. Quality control system.

M90#30. Which of the following statements about internal control structure is correct?
   a. A properly maintained internal control structure reasonably ensures that collusion among employees cannot occur.
   b. The establishment and maintenance of the internal control structure is an important responsibility of the internal auditor.
   c. An exceptionally strong internal control structure is enough for the auditor to eliminate substantive tests on a significant account balance.
   d. The cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure.

M90#31. After obtaining an understanding of an entity's internal control structure, an auditor may assess control risk at the maximum level for some assertions because the auditor
   a. Believes the internal control policies and procedures are unlikely to be effective.
   b. Determines that the pertinent internal control structure elements are not well documented.
   c. Performs tests of controls to restrict detection risk to an acceptable level.
   d. Identifies internal control policies and procedures that are likely to prevent material misstatements.

M90#32. The primary objective of procedures performed to obtain an understanding of the internal control structure is to provide an auditor with
   a. Evidential matter to use in reducing detection risk.
   b. Knowledge necessary to plan the audit.
   c. A basis from which to modify tests of controls.
   d. Information necessary to prepare flowcharts.

M90#33. Which of the following audit techniques most likely would provide an auditor with the most assurance about the effectiveness of the operation of an internal control procedure?
   a. Inquiry of client personnel.
   b. Recomputation of account balance amounts.
   c. Observation of client personnel.
   d. Confirmation with outside parties.

N89#39. When obtaining an understanding of an entity's control environment, an auditor should concentrate on the substance of management's policies and procedures rather than their form because
   a. The auditor may believe that the policies and procedures are inappropriate for that particular entity.
   b. The board of directors may not be aware of management's attitude toward the control environment.
   c. Management may establish appropriate policies and procedures but not act on them.
   d. The policies and procedures may be so weak that no reliance is contemplated by the auditor.

N89#40. After obtaining an understanding of an entity's internal control structure and assessing control risk, an auditor may next
   a. Perform tests of controls to verify management's assertions that are embodied in the financial statements.
   b. Consider whether evidential matter is available to support a further reduction in the assessed level of control risk.
   c. Apply analytical procedures as substantive tests to validate the assessed level of control risk.
   d. Evaluate whether the internal control structure policies and procedures detected material misstatements in the financial statements.

N89#41. An auditor is least likely to test the internal controls that provide for
   a. Approval of the purchase and sale of marketable securities.
   b. Classification of revenue and expense transactions by product line.
   c. Segregation of the functions of recording disbursements and reconciling the bank account.
   d. Comparison of receiving reports and vendors' invoices with purchase orders.

N89#42. The possibility of erasing a large amount of information stored on magnetic tape most likely would be reduced by the use of
   a. File protection rings.
   b. Check digits.
   c. Completeness tests.
   d. Conversion verification.

N89#43. Which of the following most likely represents a weakness in the internal control structure of an EDP system?
   a. The systems analyst reviews output and controls the distribution of output from the EDP department.
   b. The accounts payable clerk prepares data for computer processing and enters the data into the computer.
c. The systems programmer designs the operating and control functions of programs and participates in testing operating systems.

d. The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.

M89#8. As a result of tests of controls, an auditor overrelied on internal control and decreased substantive testing. This overreliance occurred because the true deviation rate in the population was

a. Less than the risk of overreliance on the auditor’s sample.
b. Less than the deviation rate in the auditor’s sample.
c. More than the risk of overreliance on the auditor’s sample.
d. More than the deviation rate in the auditor’s sample.

M89#9. A procedure that would most likely be used by an auditor in performing tests of control procedures that involve segregation of functions and that leave no transaction trail is

a. Inspection.
b. Observation.
c. Reperformance.
d. Reconciliation.

M89#10. Which of the following is not a reason an auditor should obtain an understanding of the elements of an entity’s internal control structure in planning an audit?

a. Identify the types of potential misstatements that can occur.
b. Design substantive tests.
c. Consider the operating effectiveness of the internal control structure.
d. Consider factors that affect the risk of material misstatements.

M89#11. Which of the following is not an element of an entity’s internal control structure?

a. Control risk.
b. Control procedures.
c. The accounting system.
d. The control environment.

M89#12. Errors in data processed in a batch computer system may not be detected immediately because

a. Transaction trails in a batch system are available only for a limited period of time.
b. There are time delays in processing transactions in a batch system.
c. Errors in some transactions cause rejection of other transactions in the batch.
d. Random errors are more likely in a batch system than in an on-line system.

M89#13. When EDP programs or files can be accessed from terminals, users should be required to enter a(an)

a. Parity check.
b. Personal identification code.
c. Self-diagnosis test.
d. Echo check.

N88#34. When performing the review of an internal accounting control system’s design, an auditor may obtain answers to an internal accounting control questionnaire. The next step ordinarily should be to

a. Make a preliminary evaluation of whether specific control procedures are suitably designed for reliance, assuming satisfactory compliance.
b. Perform compliance tests to provide reasonable assurance that the control procedures are being applied as prescribed.
c. Gather enough evidence to determine if the internal accounting control system is effective in preventing or detecting errors and irregularities.
d. Design substantive tests that do not contemplate reliance on the control procedures that appear to be ineffective.

N88#38. Which of the following would most likely be a weakness in the internal accounting control system of a client that utilizes microcomputers rather than a larger computer system?

a. Employee collusion possibilities are increased because microcomputers from one vendor can process the programs of a system from a different vendor.
b. The microcomputer operators may be able to remove hardware and software components and modify them at home.
c. Programming errors result in all similar transactions being processed incorrectly when those transactions are processed under the same conditions.
d. Certain transactions may be automatically initiated by the microcomputers and management’s authorization of these transactions may be implicit in its acceptance of the system design.

N88#39. During the review of a small business client’s internal accounting control system, the auditor discovered that the accounts receivable clerk approves credit memos and has access to cash. Which of the following controls would be most effective in offsetting this weakness?

a. The owner reviews errors in billings to customers and postings to the subsidiary ledger.
b. The controller receives the monthly bank statement directly and reconciles the checking accounts.
c. The owner reviews credit memos after they are recorded.
d. The controller reconciles the total of the detail accounts receivable accounts to the amount shown in the ledger.
**Auditing**

**M88#49.** Which of the following conclusions could an auditor most likely make on completing the preliminary phase of the review of internal accounting control?

a. Specific control procedures are suitably designed for the auditor to rely on to restrict the extent of substantive tests, assuming satisfactory compliance.

b. The audit effort required to study and evaluate the design of the system exceeds the reduction in audit effort that could be achieved by reliance on the system.

c. The accounting control procedures are suitably designed to provide reasonable assurance that errors and irregularities will be prevented or detected, provided functions are properly segregated.

d. Compliance tests indicate that access to computer operations is so unrestricted that the internal accounting control system can not be relied on to restrict the extent of substantive tests.

**M88#3.** Which of the following statements is *not* true of the test data approach when testing a computerized accounting system?

a. The test data need consist of only those valid and invalid conditions which interest the auditor.

b. Only one transaction of each type need be tested.

c. The test data must consist of all possible valid and invalid conditions.

d. Test data are processed by the client’s computer programs under the auditor’s control.

**M88#6.** An auditor performs a test to determine whether all merchandise for which the client was billed was received. The population for this test consists of all

a. Merchandise received.

b. Vendors’ invoices.

c. Canceled checks.

d. Receiving reports.

**M88#7.** Internal accounting control is ineffective when computer department personnel

a. Participate in computer software acquisition decisions.

b. Design documentation for computerized systems.

c. Originate changes in master files.

d. Provide physical security for program files.

**M88#9.** 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.

**M87#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.
C. Cycles

M91#28. An auditor would consider a cashier's job description to contain compatible duties if the cashier receives remittances from the mailroom and also prepares the
   a. Prelist of individual checks.
   b. Monthly bank reconciliation.
   c. Daily deposit slip.
   d. Remittance advices.

M91#29. Which of the following most likely would be an internal control procedure designed to detect errors and irregularities concerning the custody of inventory?
   a. Periodic reconciliation of work in process with job cost sheets.
   b. Segregation of functions between general accounting and cost accounting.
   c. Independent comparisons of finished goods records with counts of goods on hand.
   d. Approval of inventory journal entries by the storekeeper.

M91#30. Sound internal control procedures dictate that defective merchandise returned by customers should be presented initially to the
   a. Sales clerk.
   b. Purchasing clerk.
   c. Receiving clerk.
   d. Inventory control clerk.

M91#31. In a computerized payroll system environment, an auditor would be least likely to use test data to test controls related to
   a. Missing employee numbers.
   b. Proper approval of overtime by supervisors.
   c. Time tickets with invalid job numbers.
   d. Agreement of hours per clock cards with hours on time tickets.

M91#32. The primary responsibility of a bank acting as registrar of capital stock is to
   a. Ascertain that dividends declared do not exceed the statutory amount allowable in the state of incorporation.
   b. Account for stock certificates by comparing the total shares outstanding to the total in the shareholders subsidiary ledger.
   c. Act as an independent third party between the board of directors and outside investors concerning mergers, acquisitions, and the sale of treasury stock.
   d. Verify that stock is issued in accordance with the authorization of the board of directors and the articles of incorporation.

N90#48. The most likely result of ineffective internal control policies and procedures in the revenue cycle is that
   a. Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.

b. Omission of shipping documents could go undetected, causing an understatement of inventory.

c. Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.

d. Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.

N90#49. Proper authorization procedures in the revenue cycle usually provide for the approval of bad debt write-offs by an employee in which of the following departments?
   a. Treasurer.
   b. Sales.
   c. Billing.
   d. Accounts receivable.

N90#50. An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the control procedures leave no audit trail of documentary evidence, the auditor most likely will test the procedures by
   a. Inquiry and analytical procedures.
   b. Confirmation and observation.
   c. Observation and inquiry.
   d. Analytical procedures and confirmation.

N90#51. Which of the following controls would be most effective in assuring that recorded purchases are free of material errors?
   a. The receiving department compares the quantity ordered on purchase orders with the quantity received on receiving reports.
   b. Vendors' invoices are compared with purchase orders by an employee who is independent of the receiving department.
   c. Receiving reports require the signature of the individual who authorized the purchase.
   d. Purchase orders, receiving reports, and vendors' invoices are independently matched in preparing vouchers.

N90#52. The objectives of the internal control structure for a production cycle are to provide assurance that transactions are properly executed and recorded, and that
   a. Independent internal verification of activity reports is established.
   b. Transfers to finished goods are documented by a completed production report and a quality control report.
   c. Production orders are prenumbered and signed by a supervisor.
   d. Custody of work in process and of finished goods is properly maintained.
Auditing

M90#53. Effective internal control procedures over the payroll function may include
   a. Reconciliation of totals on job time tickets with job reports by employees responsible for those specific jobs.
   b. Verification of agreement of job time tickets with employee clock card hours by a payroll department employee.
   c. Preparation of payroll transaction journal entries by an employee who reports to the supervisor of the personnel department.
   d. Custody of rate authorization records by the supervisor of the payroll department.

M90#54. Which of the following controls would be most effective in assuring that the proper custody of assets in the investing cycle is maintained?
   a. Direct access to securities in the safety deposit box is limited to only one corporate officer.
   b. Personnel who post investment transactions to the general ledger are not permitted to update the investment subsidiary ledger.
   c. The purchase and sale of investments are executed on the specific authorization of the board of directors.
   d. The recorded balances in the investment subsidiary ledger are periodically compared with the contents of the safety deposit box by independent personnel.

M90#34. Tracing bills of lading to sales invoices provides evidence that
   a. Shipments to customers were invoiced.
   b. Shipments to customers were recorded as sales.
   c. Recorded sales were shipped.
   d. Invoiced sales were shipped.

M90#35. Employers bond employees who handle cash receipts because fidelity bonds reduce the possibility of employing dishonest individuals and
   a. Protect employees who make unintentional errors from possible monetary damages resulting from their errors.
   b. Deter dishonesty by making employees aware that insurance companies may investigate and prosecute dishonest acts.
   c. Facilitate an independent monitoring of the receiving and depositing of cash receipts.
   d. Force employees in positions of trust to take periodic vacations and rotate their assigned duties.

M90#36. To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all
   a. Vendor's invoices.
   b. Purchase orders.
   c. Receiving reports.
   d. Canceled checks.

M90#37. Which of the following control procedures is not usually performed in the vouchers payable department?
   a. Determining the mathematical accuracy of the vendor's invoice.
   b. Having an authorized person approve the voucher.
   c. Controlling the mailing of the check and remittance advice.
   d. Matching the receiving report with the purchase order.

M90#38. Which of the following internal control procedures most likely addresses the completeness assertion for inventory?
   a. Work in process account is periodically reconciled with subsidiary records.
   b. Employees responsible for custody of finished goods do not perform the receiving function.
   c. Receiving reports are prenumbered and periodically reconciled.
   d. There is a separation of duties between payroll department and inventory accounting personnel.

M90#39. The sampling unit in a test of controls pertaining to the existence of payroll transactions ordinarily is a(an)
   a. Clock card or time ticket.
   b. Employee Form W-2.
   c. Employee personnel record.
   d. Payroll register entry.

M89#45. An internal control narrative indicates that an approved voucher is required to support every check request for payment of merchandise. Which of the following procedures provides the greatest assurance that this control is operating effectively?
   a. Select and examine vouchers and ascertain that the related cancelled checks are dated no later than the vouchers.
   b. Select and examine vouchers and ascertain that the related cancelled checks are dated no earlier than the vouchers.
   c. Select and examine cancelled checks and ascertain that the related vouchers are dated no earlier than the checks.
   d. Select and examine cancelled checks and ascertain that the related vouchers are dated no later than the checks.

M89#46. For effective internal control purposes, the vouchers payable department generally should
   a. Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
   b. Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.
Selected Questions

c. Obliterate the quantity ordered on the receiving department copy of the purchase order.
d. Establish the agreement of the vendor's invoice with the receiving report and purchase order.

N89#47. An auditor's tests of controls over the issuance of raw materials to production would most likely include
a. Reconciling raw materials and work in process perpetual inventory records to general ledger balances.
b. Inquiring of the custodian about the procedures followed when defective materials are received from vendors.
c. Observing that raw materials are stored in secure areas and that storeroom security is supervised by a responsible individual.
d. Examining material requisitions and reperforming client controls designed to process and record issuances.

N89#48. A weakness in internal control over recording retirements of equipment may cause an auditor to
a. Trace additions to the "other assets" account to search for equipment that is still on hand but no longer being used.
b. Select certain items of equipment from the accounting records and locate them in the plant.
c. Inspect certain items of equipment in the plant and trace those items to the accounting records.
d. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.

N89#14. When goods are received, the receiving clerk should match the goods with the
a. Purchase order and the requisition form.
b. Vendor's invoice and the receiving report.
c. Vendor's shipping document and the purchase order.
d. Receiving report and the vendor's shipping document.

N89#15. The mailing of disbursement checks and remittance advices should be controlled by the employee who
a. Signed the checks last.
b. Approved the vouchers for payment.
c. Matched the receiving reports, purchase orders, and vendors' invoices.
d. Verified the mathematical accuracy of the vouchers and remittance advices.

N89#17. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the
a. Administrative controls from the internal accounting controls.

b. Human resources function from the controllership function.
c. Operational responsibility from the record keeping responsibility.
d. Authorization of transactions from the custody of related assets.

M89#18. Independent internal verification of inventory occurs when employees who
a. Issue raw materials obtain material requisitions for each issue and prepare daily totals of materials issued.
b. Compare records of goods on hand with physical quantities do not maintain the records or have custody of the inventory.
c. Obtain receipts for the transfer of completed work to finished goods prepare a completed production report.
d. Are independent of issuing production orders update records from completed job cost sheets and production cost reports on a timely basis.

M89#19. When there are numerous property and equipment transactions during the year, an auditor planning to assess control risk at the minimum level usually plans to obtain an understanding of the internal control structure and to perform
a. Tests of controls and extensive tests of property and equipment balances at the end of the year.
b. Extensive tests of current year property and equipment transactions.
c. Tests of controls and limited tests of current year property and equipment transactions.
d. Analytical procedures for property and equipment balances at the end of the year.

N88#40. At which point in an ordinary sales transaction of a wholesaling business would a lack of specific authorization least concern the auditor conducting an audit?

a. Determining discounts.
b. Selling goods for cash.
c. Granting credit.
d. Shipping goods.

N88#41. Cash receipts from sales on account have been misappropriated. Which of the following acts would conceal this defalcation and be least likely to be detected by an auditor?

a. Understating the sales journal.
b. Overstating the accounts receivable control account.
c. Overstating the accounts receivable subsidiary ledger.
d. Understating the cash receipts journal.
N88#42. For effective internal accounting control, the accounts payable department should compare the information on each vendor’s invoice with the
   a. Receiving report and the purchase order.
   b. Receiving report and the voucher.
   c. Vendor’s packing slip and the purchase order.
   d. Vendor’s packing slip and the voucher.

N88#43. Which of the following is the most effective control procedure to detect vouchers that were prepared for the payment of goods that were not received?
   a. Count goods upon receipt in storeroom.
   b. Match purchase order, receiving report, and vendor’s invoice for each voucher in accounts payable department.
   c. Compare goods received with goods requisitioned in receiving department.
   d. Verify vouchers for accuracy and approval in internal audit department.

N88#44. Which of the following control procedures would most likely be used to maintain accurate perpetual inventory records?
   a. Independent storeroom count of goods received.
   b. Periodic independent reconciliation of control and subsidiary records.
   c. Periodic independent comparison of records with goods on hand.
   d. Independent matching of purchase orders, receiving reports, and vendors’ invoices.

N88#45. If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll EDP application?
   a. Hours worked.
   b. Total debits and total credits.
   c. Net pay.
   d. Department numbers.

N88#46. Which of the following procedures is most likely to prevent the improper disposition of equipment?
   a. A separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders.
   b. The use of serial numbers to identify equipment that could be sold.
   c. Periodic comparison of removal work orders to authorizing documentation.
   d. A periodic analysis of the scrap sales and the repairs and maintenance accounts.

M88#10. Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for
   a. Investigation of variances within a formal budgeting system.
   b. Review and approval of the monthly depreciation entry by the plant supervisor.
   c. Segregation of duties of employees in the accounts payable department.
   d. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

M88#20. Which of the following procedures in the cash disbursements cycle should not be performed by the accounts payable department?
   a. Comparing the vendor’s invoice with the receiving report.
   b. Canceling supporting documentation after payment.
   c. Verifying the mathematical accuracy of the vendor’s invoice.
   d. Signing the voucher for payment by an authorized person.

M87#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.

M87#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.

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.
Selected Questions

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.
   b. Select and examine cancelled checks and ascertain that the related receiving reports are dated no later than the checks.
   c. Select and examine receiving reports and ascertain that the related cancelled checks are dated no earlier than the receiving reports.
   d. Select and examine receiving reports and ascertain that the related cancelled checks are dated no later than the receiving reports.

M87#15. In a properly designed internal accounting control system, the same employee may be permitted to
   a. Receive and deposit checks, and also approve write-offs of customer accounts.
   b. Approve vouchers for payment, and also sign checks.
   c. Reconcile the bank statements, and also receive and deposit cash.
   d. Sign checks, and also cancel supporting documents.

M87#16. Instead of taking a physical inventory count on the balance-sheet date the client may take physical counts prior to the year-end if internal accounting controls are adequate and
   a. Computerized records of perpetual inventory are maintained.
   b. Inventory is slow-moving.
   c. EDP error reports are generated for missing prenumbered inventory tickets.
   d. Obsolete inventory items are segregated and excluded.

M87#17. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?
   a. Reconciliation of work in process inventory with cost records.
   b. Comparison of daily journal entries with factory labor summary.
   c. Comparison of periodic cost budgets and time cards.
   d. Reconciliation of unfinished job summary and production cost records.

M87#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.
D. Other Considerations

M91#33. An auditor's communication of internal control structure related matters noted in an audit usually should be addressed to the
   a. Audit committee.
   b. Director of internal auditing.
   c. Chief financial officer.
   d. Chief accounting officer.

M91#34. When reporting on conditions relating to an entity's internal control structure observed during an audit of the financial statements, the auditor should include a
   a. Description of tests performed to search for material weaknesses.
   b. Statement of positive assurance on the structure.
   c. Paragraph describing the inherent limitations of the structure.
   d. Restriction on the distribution of the report.

M91#35. A previously communicated reportable condition that has not been corrected ordinarily should be communicated again if
   a. The deficiency has a material effect on the auditor's assessment of control risk.
   b. The entity accepts that degree of risk because of cost-benefit considerations.
   c. The weakness could adversely affect the entity's ability to report financial data.
   d. There has been major turnover in upper-level management and the board of directors.

M91#36. An accountant's report expressing an unqualified opinion on an entity's system of internal accounting control should contain a
   a. Description of the difference between the expression of an opinion on the system and the assessment of control risk made as part of an audit.
   b. Statement that the establishment and maintenance of the system is the responsibility of management.
   c. Statement that the distribution of the accountant's report is limited to the entity's management and its board of directors.
   d. Description of the material weaknesses that may permit errors or irregularities to occur and not be detected.

M91#37. An engagement to express an opinion on a system of internal accounting control will generally
   a. Require procedures that duplicate those already applied in assessing control risk during a financial statement audit.
   b. Increase the reliability of the financial statements that have already been audited.
   c. Be more extensive in scope than the assessment of control risk made during a financial statement audit.
   d. Be more limited in scope than the assessment of control risk made during a financial statement audit.

M91#39. In performing tests of controls over authorization of cash disbursements, which of the following sampling methods would be most appropriate?
   a. Ratio.
   b. Attributes.
   c. Variables.
   d. Stratified.

M91#40. Samples to test internal control structure procedures are intended to provide a basis for an auditor to conclude whether
   a. The control procedures are operating effectively.
   b. The financial statements are materially misstated.
   c. The risk of incorrect acceptance is too high.
   d. Materiality for planning purposes is at a sufficiently low level.

M91#47. The GAO standards of reporting for governmental financial audits incorporate the AICPA standards of reporting and prescribe supplemental standards to satisfy the unique needs of governmental audits. Which of the following is a supplemental reporting standard for government financial audits?
   a. A written report on the auditor's understanding of the entity's internal control structure and assessment of control risk should be prepared.
   b. Material indications of illegal acts should be reported in a document with distribution restricted to senior officials of the entity audited.
   c. Instances of abuse, fraud, mismanagement, and waste should be reported to the organization with legal oversight authority over the entity audited.
   d. All privileged and confidential information discovered should be reported to the senior officials of the organization that arranged for the audit.

M90#55. Which of the following statements concerning material weaknesses and reportable conditions is correct?
   a. An auditor should identify and communicate material weaknesses separately from reportable conditions.
   b. All material weaknesses are reportable conditions.
   c. An auditor should report immediately material weaknesses and reportable conditions discovered during an audit.
   d. All reportable conditions are material weaknesses.
Selected Questions

N90#56. An accountant's report expressing an unqualified opinion on an entity's system of internal accounting control should state that the

a. Engagement is different in purpose and scope from obtaining an understanding of the internal control structure and assessing control risk as part of an audit.

b. Accountant's opinion does not necessarily increase the reliability of the entity's financial statements unless they are audited.

c. System taken as a whole is sufficient to meet the broad objectives pertaining to preventing or detecting material errors or irregularities.

d. Accountant did not apply procedures in the engagement that duplicate those procedures previously applied in assessing control risk as part of an audit.

N90#57. Cain Company's management engaged Bell, CPA, to express an opinion on Cain's system of internal accounting control. Bell's report described several material weaknesses and potential errors and irregularities that could occur. Subsequently, management included Bell's report in its annual report to the Board of Directors with a statement that the cost of correcting the weaknesses would exceed the benefits. Bell should

a. Not express an opinion as to management's cost-benefit statement.

b. Advise the Board that Bell either agrees or disagrees with management's statement.

c. Advise management that Bell's report was restricted for use only by management.

d. Advise both management and the Board that Bell was withdrawing the opinion.

N90#58. To determine the sample size for a test of controls, an auditor should consider the tolerable deviation rate, the allowable risk of assessing control risk too low, and the

a. Expected deviation rate.

b. Upper precision limit.

c. Risk of incorrect acceptance.

d. Risk of incorrect rejection.

N90 Items 59 and 60 are based on the following:

An auditor desired to test credit approval on 10,000 sales invoices processed during the year. The auditor designed a statistical sample that would provide 1% risk of assessing control risk too low (99% confidence) that not more than 7% of the sales invoices lacked approval. The auditor estimated from previous experience that about 2½% of the sales invoices lacked approval. A sample of 200 invoices was examined and 7 of them were lacking approval. The auditor then determined the achieved upper precision limit to be 8%.

59. In the evaluation of this sample, the auditor decided to increase the level of the preliminary assessment of control risk because the

a. Tolerable rate (7%) was less than the achieved upper precision limit (8%).

b. Expected deviation rate (7%) was more than the percentage of errors in the sample (3½%).

c. Achieved upper precision limit (8%) was more than the percentage of errors in the sample (3½%).

d. Expected deviation rate (2½%) was less than the tolerable rate (7%).

60. The allowance for sampling risk was

a. 5½%

b. 4½%

c. 3½%

d. 1 %

M90#40. How do the scope, procedures, and purpose of an engagement to express an opinion on an entity's system of internal accounting control compare to those for obtaining an understanding of the internal control structure and assessing control risk as part of an audit?

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<thead>
<tr>
<th>Scope</th>
<th>Procedures</th>
<th>Purpose</th>
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<tr>
<td>a.</td>
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<td>Different</td>
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<td>b.</td>
<td>Different</td>
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<td>c.</td>
<td>Different</td>
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<tr>
<td>d.</td>
<td>Different</td>
<td>Similar</td>
</tr>
</tbody>
</table>

M90#41. When engaged to express an opinion on an entity's system of internal accounting control, an accountant should

a. Obtain management's written representations acknowledging responsibility for establishing and maintaining the system.

b. Qualify any opinion concerning management's assertion that the cost of correcting any weaknesses exceeds the benefits.

c. Keep informed of events subsequent to the date of the report that might have affected the accountant's opinion.

d. Disclaim an opinion on whether the system taken as a whole is sufficient to prevent or detect material errors or irregularities.

M90#42. The likelihood of assessing control risk too high is the risk that the sample selected to test controls

a. Does not support the tolerable error for some or all of management's assertions.

b. Does not support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such an assessment.

c. Contains misstatements that could be material to the financial statements when aggregated with misstatements in other account balances or transaction classes.

d. Contains proportionately fewer monetary errors or deviations from prescribed internal control structure policies or procedures than exist in the balance or class as a whole.
M90#43. An auditor is testing internal control procedures that are evidenced on an entity's vouchers by matching random numbers with voucher numbers. If a random number matches the number of a voided voucher, that voucher ordinarily should be replaced by another voucher in the random sample if the voucher a. Constitutes a deviation.
b. Has been properly voided.
c. Cannot be located.
d. Represents an immaterial dollar amount.

M90#44. The risk of incorrect acceptance and the likelihood of assessing control risk too low relate to the a. Effectiveness of the audit.
b. Efficiency of the audit.
c. Preliminary estimates of materiality levels.
d. Allowable risk of tolerable error.

M90

Item 45 is based on the following section of a system flowchart for a payroll application

M90#50. An accountant's report expressing an opinion on an entity's internal controls should
a. Briefly explain the broad objectives and inherent limitations of internal control.
b. State that the study and evaluation of the internal controls was conducted in accordance with generally accepted auditing standards.
c. Clearly disclaim responsibility for the establishment and maintenance of the internal controls.
d. Include an opinion concerning management's assertions about whether the cost of correcting any material weaknesses would exceed the benefits of reducing the risk of errors and irregularities.

M90#51. An accountant has been engaged to report on an entity's internal controls without performing an audit of the financial statements. What restrictions, if any, should the accountant place on the use of this report?

a. This report should be restricted for use by management.
b. This report should be restricted for use by the audit committee.
c. This report should be restricted for use by a specified regulatory agency.
d. The accountant does not need to place any restrictions on the use of this report.

M90#52. Which of the following combinations results in a decrease in sample size in a sample for attributes?

<table>
<thead>
<tr>
<th>Risk of overreliance</th>
<th>Tolerable rate</th>
<th>Expected population deviation rate</th>
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<tbody>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
<td>Increase</td>
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<tr>
<td>b. Decrease</td>
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<tr>
<td>c. Increase</td>
<td>Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Increase</td>
<td>Increase</td>
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</tbody>
</table>

M90#53. What is an auditor's evaluation of a statistical sample for attributes when a test of 100 documents results in 4 deviations if tolerable rate is 5%, the expected population deviation rate is 3%, and the allowance for sampling risk is 2%?

a. Accept the sample results as support for planned reliance on the control because the tolerable rate less the allowance for sampling risk equals the expected population deviation rate.
b. Modify planned reliance on the control because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.
c. Modify planned reliance on the control because the tolerable rate plus the allowance for sampling risk exceeds the expected population deviation rate.
d. Accept the sample results as support for planned reliance on the control because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.
Selected Questions

**N89#54.** A principal advantage of statistical methods of attribute sampling over nonstatistical methods is that they provide a scientific basis for planning the

a. Risk of overreliance.
b. Tolerable rate.
c. Expected population deviation rate.
d. Sample size.

**N89#55.** Which of the following symbolic representations indicates that new payroll transactions and the old payroll file have been used to prepare payroll checks, prepare a printed payroll journal, and generate a new payroll file?

a.  

b.  

c.  

d.  

**N89#58.** Reportable conditions are matters that come to an auditor’s attention, which should be communicated to an entity’s audit committee because they represent

a. Material irregularities or illegal acts perpetrated by high-level management.
b. Significant deficiencies in the design or operation of the internal control structure.
c. Flagrant violations of the entity’s documented conflict-of-interest policies.
d. Intentional attempts by client personnel to limit the scope of the auditor’s field work.

**M89#20.** Which of the following statements is correct concerning an auditor’s communication of internal control structure related matters (reportable conditions) noted in an audit?

a. The auditor may issue a written report to the audit committee representing that no reportable conditions were noted during the audit.
b. Reportable conditions should be communicated each year even if the audit committee has acknowledged its understanding of such deficiencies.
c. Reportable conditions may not be communicated in a document that contains suggestions regarding activities that concern other topics such as business strategies or administrative efficiencies.
d. The auditor may choose to communicate significant internal control structure related matters either during the course of the audit or after the audit is concluded.

**M89#21.** An accountant’s report expressing an opinion on an entity’s internal controls should contain a

a. Statement that the entity’s internal controls are consistent with that of the prior year after giving effect to subsequent changes.
b. Brief explanation of the broad objectives and inherent limitations of internal control.
c. Description of the principal controls that protect assets against loss from unauthorized use or disposition.
d. Statement that the engagement was conducted in accordance with generally accepted auditing standards.

**M89#22.** An independent accountant, without auditing an entity’s financial statements, may accept an engagement to express an opinion on the entity’s internal controls in effect

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<th>As of a specified date</th>
<th>During a specified period of time</th>
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<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<td>c. No</td>
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<td>d. No</td>
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</table>
**Auditing**

**M89#23.** An auditor who uses statistical sampling for attributes in testing internal controls should reduce the planned reliance on a prescribed control when the
   a. Sample rate of deviation is less than the expected rate of deviation used in planning the sample.
   b. Tolerable rate less the allowance for sampling risk exceeds the sample rate of deviation.
   c. Sample rate of deviation plus the allowance for sampling risk exceeds the tolerable rate.
   d. Sample rate of deviation plus the allowance for sampling risk equals the tolerable rate.

**M89#24.** Which of the following factors is generally not considered in determining the sample size for a test of controls?
   b. Tolerable rate.
   c. Risk of overreliance.
   d. Expected population deviation rate.

**M89#25.** An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods
   a. Afford greater assurance than a nonstatistical sample of equal size.
   b. Provide an objective basis for quantitatively evaluating sample risks.
   c. Can more easily convert the sample into a dual-purpose test useful for substantive testing.
   d. Eliminate the need to use judgment in determining appropriate sample sizes.

**N88#35.** An auditor’s study and evaluation of the internal accounting control system made in connection with an annual audit is usually not sufficient to express an opinion on an entity’s system because
   a. The evaluation of weaknesses is subjective enough that an auditor should not express an opinion on the internal accounting controls alone.
   b. The audit cost-benefit relationship permits an auditor to express only reasonable assurance that the system operates as designed.
   c. Management may change the internal accounting controls to correct weaknesses.
   d. Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.

**N88#47.** Which of the following statements is correct concerning the auditor’s required communication of a material weakness in internal accounting control?
   a. A weakness that management refuses to correct should be included in a separate paragraph of the auditor’s report.
   b. A weakness previously communicated during the prior year’s audit that has not been correct should be communicated again in writing.
   c. Suggested corrective action for management’s consideration concerning a weakness need not be communicated to the client.
   d. The auditor should test for compliance any weakness discovered before communicating it to the client.

**N88#48.** A CPA has performed an examination of the general purpose financial statements of Big City. The examination scope included the additional requirements of the Single Audit Act. When reporting on Big City’s internal accounting and administrative controls used in administering a federal financial assistance program, the CPA should
   a. Communicate those weaknesses that are material in relation to the general purpose financial statements.
   b. Express an opinion on the systems used to administer major federal financial assistance programs and express negative assurance on the systems used to administer nonmajor federal financial assistance programs.
   c. Communicate those weaknesses that are material in relation to the federal financial assistance program.
   d. Express negative assurance on the systems used to administer major federal financial assistance programs and express no opinion on the systems used to administer nonmajor federal financial assistance programs.

**N88 Item 60 is based on the following flowchart:**

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A-24
Selected Questions

60. In a credit sales and cash receipts system flowchart symbol X could represent
   a. Auditor's test data.
   b. Remittance advices.
   c. Error reports.
   d. Credit authorization forms.

N88#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.

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#51. Which of the following statements is correct concerning the auditor's required communication of material weaknesses in internal accounting control?
   a. If the auditor does not become aware of any material weaknesses during the examination, that fact must be communicated.
   b. Weaknesses reported at interim dates should be tested for correction before completion of the engagement.
   c. Although written communication is preferable, the auditor may communicate the findings orally.
   d. Weaknesses reported at interim dates must be repeated in the communication at the completion of the engagement.

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#10. 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.
Auditing

Items 24 and 25 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.

III. Evidence and Procedures

A. Audit Evidence

M91#1. Which of the following statements concerning evidential matter is correct?
   a. Competent evidence supporting management's assertions should be convincing rather than merely persuasive.
   b. An effective internal control structure contributes little to the reliability of the evidence created within the entity.
   c. The cost of obtaining evidence is not an important consideration to an auditor in deciding what evidence should be obtained.
   d. A client’s accounting data cannot be considered sufficient audit evidence to support the financial statements.

M91#2. An auditor’s purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management’s assertions about
   a. Presentation and disclosure.
   b. Existence or occurrence.
   c. Rights and obligations.
   d. Valuation or allocation.

M91#3. An auditor’s purpose in reviewing the renewal of a note payable shortly after the balance sheet date most likely is to obtain evidence concerning management’s assertions about
   a. Existence or occurrence.
   b. Presentation and disclosure.
   c. Completeness.
   d. Valuation or allocation.

M91#4. A basic premise underlying the application of analytical procedures is that
   a. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
   b. Statistical tests of financial information may lead to the discovery of material errors in the financial statements.
   c. Plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.
   d. These procedures cannot replace tests of balances and transactions.
Selected Questions

N90#18. In an audit of inventories, an auditor would least likely verify that
   a. All inventory owned by the client is on hand at the time of the count.
   b. The client has used proper inventory pricing.
   c. The financial statement presentation of inventories is appropriate.
   d. Damaged goods and obsolete items have been properly accounted for.

N90#19. The scope of an audit is not restricted when an attorney’s response to an auditor as a result of a client’s letter of audit inquiry limits the response to
   a. Matters to which the attorney has given substantive attention in the form of legal representation.
   b. An evaluation of the likelihood of an unfavorable outcome of the matters disclosed by the entity.
   c. The attorney’s opinion of the entity’s historical experience in recent similar litigation.
   d. The probable outcome of asserted claims and pending or threatened litigation.

N90#20. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
   a. Management acknowledges that there are no material weaknesses in the internal control structure.
   b. Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
   c. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
   d. Management acknowledges responsibility for illegal actions committed by employees.

N90#21. Two assertions for which confirmation of accounts receivable balances provides primary evidence are
   a. Completeness and valuation.
   b. Valuation and rights and obligations.
   c. Rights and obligations and existence.
   d. Existence and completeness.

N90#22. For all audits of financial statements made in accordance with generally accepted auditing standards, the use of analytical procedures is required to some extent

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<th>In the planning stage</th>
<th>As a substantive test</th>
<th>In the review stage</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
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<td>b. No</td>
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<td>c. No</td>
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<td>d. Yes</td>
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N90#16. The third standard of field work states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. The substantive evidential matter required by this standard may be obtained, in part, through
   a. Flowcharting the internal control structure.
   b. Proper planning of the audit engagement.
   c. Analytical procedures.
   d. Auditor working papers.

N90#17. In testing the existence assertion for an asset, an auditor ordinarily works from the
   a. Financial statements to the potentially unrecorded items.
   b. Potentially unrecorded items to the financial statements.
   c. Accounting records to the supporting evidence.
   d. Supporting evidence to the accounting records.

N91#5. Which of the following comparisons would be most useful to an auditor in evaluating the results of an entity’s operations?  
   a. Prior year accounts payable to current year accounts payable.
   b. Prior year payroll expense to budgeted current year payroll expense.
   c. Current year revenue to budgeted current year revenue.
   d. Current year warranty expense to current year contingent liabilities.

N91#6. To which of the following matters would an auditor not apply materiality limits when obtaining specific written client representations?
   b. Information concerning related party transactions and related amounts receivable or payable.
   c. The absence of errors and unrecorded transactions in the financial statements.
   d. Irregularities involving employees with significant roles in the internal control structure.

N91#7. Which of the following statements concerning the auditor’s use of the work of a specialist is correct?
   a. If the auditor believes that the determinations made by the specialist are unreasonable, only a qualified opinion may be issued.
   b. If the specialist is related to the client, the auditor is still permitted to use the specialist’s findings as corroborative evidence.
   c. The specialist need not have an understanding of the auditor’s corroborative use of the specialist’s findings.
   d. The specialist may be identified in the auditor’s report when the auditor issues an unqualified opinion.

N90#18. In an audit of inventories, an auditor would least likely verify that
Auditing

M90#23. Auditors try to identify predictable relationships when using analytical procedures. Relationships involving transactions from which of the following accounts most likely would yield the highest level of evidence?
   a. Accounts payable.
   b. Advertising expense.
   c. Accounts receivable.
   d. Payroll expense.

M90#1. As the acceptable level of detection risk decreases, an auditor may change the
   a. Timing of substantive tests by performing them at an interim date rather than at year end.
   b. Nature of substantive tests from a less effective to a more effective procedure.
   c. Timing of tests of controls by performing them at several dates rather than at one time.
   d. Assessed level of inherent risk to a higher amount.

M90#2. Which of the following factors would least influence an auditor's consideration of the reliability of data for purposes of analytical procedures?
   a. Whether the data were processed in an EDP system or in a manual accounting system.
   b. Whether sources within the entity were independent of those who are responsible for the amount being audited.
   c. Whether the data were subjected to audit testing in the current or prior year.
   d. Whether the data were obtained from independent sources outside the entity or from sources within the entity.

M90#5. An auditor testing long-term investments would ordinarily use analytical procedures to ascertain the reasonableness of the
   a. Existence of unrealized gains or losses in the portfolio.
   b. Completeness of recorded investment income.
   c. Classification between current and noncurrent portfolios.
   d. Valuation of marketable equity securities.

M90#26. When using the work of a specialist, an auditor may refer to and identify the specialist in the auditor's report if the
   a. Auditor wishes to indicate a division of responsibility.
   b. Specialist's work provides the auditor greater assurance of reliability.
   c. Auditor expresses an adverse opinion as a result of the specialist's findings.
   d. Specialist is not independent of the client.

M89#27. Negative confirmation of accounts receivable is less effective than positive confirmation of accounts receivable because
   a. A majority of recipients usually lack the willingness to respond objectively.
   b. Some recipients may report incorrect balances that require extensive follow-up.
   c. The auditor can not infer that all nonrespondents have verified their account information.
   d. Negative confirmations do not produce evidential matter that is statistically quantifiable.

M89#1. Each of the following might, by itself, form a valid basis for an auditor to decide to omit a test except for the
   a. Difficulty and expense involved in testing a particular item.
   b. Degree of reliance on the relevant internal controls.
   c. Relative risk involved.
   d. Relationship between the cost of obtaining evidence and its usefulness.

M89#27. The primary objective of analytical procedures used in the final review stage of an audit is to
   a. Obtain evidence from details tested to corroborate particular assertions.
   b. Identify areas that represent specific risks relevant to the audit.
   c. Assist the auditor in assessing the validity of the conclusions reached.
   d. Satisfy doubts when questions arise about a client's ability to continue in existence.

M89#28. To help plan the nature, timing, and extent of substantive auditing procedures, preliminary analytical procedures should focus on
   a. Enhancing the auditor's understanding of the client's business and events that have occurred since the last audit date.
   b. Developing plausible relationships that corroborate anticipated results with a measurable amount of precision.
   c. Applying ratio analysis to externally generated data such as published industry statistics or price indices.
   d. Comparing recorded financial information to the results of other tests of transactions and balances.

M89#29. Cooper, CPA, is auditing the financial statements of a small rural municipality. The receivable balances represent residents' delinquent real estate taxes. The internal control structure at the municipality is
Selected Questions

weak. To determine the existence of the accounts receivable balances at the balance sheet date, Cooper would most likely
   a. Send positive confirmation requests.
   b. Send negative confirmation requests.
   c. Examine evidence of subsequent cash receipts.
   d. Inspect the internal records such as copies of the tax invoices that were mailed to the residents.

M88#30. An auditor would most likely verify the interest earned on bond investments by
   a. Vouching the receipt and deposit of interest checks.
   b. Confirming the bond interest rate with the issuer of the bonds.
   c. Recomputing the interest earned on the basis of face amount, interest rate, and period held.
   d. Testing the internal controls over cash receipts.

M88#32. Auditors should request that an audit client send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims, or assessments. The primary reason for this request is to provide
   a. Information concerning the progress of cases to date.
   b. Corroborative evidential matter.
   c. An estimate of the dollar amount of the probable loss.
   d. An expert opinion as to whether a loss is possible, probable, or remote.

M88#34. A written client representation letter most likely would be an auditor’s best source of corroborative information of a client’s plans to
   a. Terminate an employee pension plan.
   b. Make a public offering of its common stock.
   c. Settle an outstanding lawsuit for an amount less than the accrued loss contingency.
   d. Discontinue a line of business.

M88#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.

M88#53. An auditor should obtain evidential matter relevant to all the following factors concerning third-party litigation against a client except the
   a. Period in which the underlying cause for legal action occurred.
   b. Probability of an unfavorable outcome.
   c. Jurisdiction in which the matter will be resolved.
   d. Existence of a situation indicating an uncertainty as to the possible loss.

M88#21. Which of the following statements is generally correct about the competence of evidential matter?
   a. The auditor’s direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources.
   b. To be competent, evidential matter must be either valid or relevant, but need not be both.
   c. Accounting data alone may be considered sufficient competent evidential matter to issue an unqualified opinion on financial statements.
   d. Competence of evidential matter refers to the amount of corroborative evidence to be obtained.

M88#22. To establish the existence and ownership of a long-term investment in the common stock of a publicly-traded company, an auditor ordinarily performs a security count or
   a. Relies on the client’s internal accounting controls if the auditor has reasonable assurance that the control procedures are being applied as prescribed.
   b. Confirms the number of shares owned that are held by an independent custodian.
   c. Determines the market price per share at the balance sheet date from published quotations.
   d. Confirms the number of shares owned with the issuing company.

M88#24. An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the
   a. Valuation of marketable equity securities.
   b. Classification of gains and losses on the disposal of securities.
   c. Completeness of recorded investment income.
   d. Existence and ownership of investments.

M88#46. “Provision has been made for any material loss that might be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.” The foregoing passage is most likely from
   a. A management representation letter.
   b. The explanatory paragraph of an “except for” qualified auditor’s report.
   c. A vendor representation letter.
   d. The explanatory paragraph of a “subject to” qualified auditor’s report.
**Auditing**

**M87#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.

**M87#33.** One reason why an auditor makes an analytical review of the client's operations is to identify

a. Improper separation of accounting and other financial duties.

b. Weaknesses of a material nature in the system of internal accounting control.

c. Unusual transactions.

d. Non-compliance with prescribed control procedures.

**M87#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.

**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#27.** Audit evidence can come in different forms with different degrees of persuasiveness. Which of the following is the least persuasive type of evidence?

a. Bank statement obtained from the client.

b. Computations made by the auditor.

c. Prenumbered client sales invoices.

d. Vendor's invoice.

**M87#28.** An example of an analytical review procedure is the comparison of

a. Financial information with similar information regarding the industry in which the entity operates.

b. Recorded amounts of major disbursements with appropriate invoices.

c. Results of a statistical sample with the expected characteristics of the actual population.

d. EDP generated data with similar data generated by a manual accounting system.

**M87#30.** When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that

a. All goods purchased before year-end are received before the physical inventory count.

b. No goods held on consignment for customers are included in the inventory balance.

c. No goods observed during the physical count are pledged or sold.

d. All goods owned at year-end are included in the inventory balance.

**M87#31.** Which of the following is the most effective audit procedure for verification of dividends earned on investments in marketable equity securities?

a. Tracing deposit of dividend checks to the cash receipts book.

b. Reconciling amounts received with published dividend records.

c. Comparing the amounts received with preceding year dividends received.

d. Recomputing selected extensions and footings of dividend schedules and comparing totals to the general ledger.

**M87#32.** Which of the following auditing procedures is ordinarily performed last?

a. Obtaining a management representation letter.

b. Testing the purchasing function.

c. Reading the minutes of directors' meetings.

d. Confirming accounts payable.

**M87#46.** Which of the following statements concerning the auditor's use of the work of a specialist is correct?

a. If the specialist is related to the client, the auditor is not permitted to use the specialist’s findings as corroborative evidence.

b. The specialist may be identified in the auditor's report only when the auditor issues a qualified opinion.
Selected Questions

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.

B. Specific Audit Objectives and Procedures

M91#8. An auditor’s program to examine long-term debt most likely would include steps that require
a. Comparing the carrying amount of the debt to its year-end market value.
b. Correlating interest expense recorded for the period with outstanding debt.
c. Verifying the existence of the holders of the debt by direct confirmation.
d. Inspecting the accounts payable subsidiary ledger for unrecorded long-term debt.

M91#9. The negative request form of accounts receivable confirmation is useful particularly when the

<table>
<thead>
<tr>
<th>Assessed level of control risk relating to receivables is</th>
<th>Number of small balances is</th>
<th>Consideration by the recipient is</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Low</td>
<td>Many</td>
<td>Likely</td>
</tr>
<tr>
<td>b. Low</td>
<td>Few</td>
<td>Unlikely</td>
</tr>
<tr>
<td>c. High</td>
<td>Few</td>
<td>Likely</td>
</tr>
<tr>
<td>d. High</td>
<td>Many</td>
<td>Likely</td>
</tr>
</tbody>
</table>

M91#10. Which of the following audit procedures is best for identifying unrecorded trade accounts payable?

a. Examining unusual relationships between monthly accounts payable balances and recorded cash payments.
b. Reconciling vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.
c. Reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
d. Investigating payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.

M91#12. An auditor ordinarily uses a working trial balance resembling the financial statements without footnotes, but containing columns for
a. Reclassifications and adjustments.
b. Reconciliations and tickmarks.
c. Accruals and deferrals.
d. Expense and revenue summaries.

M91#13. The current file of an auditor’s working papers most likely would include a copy of the
a. Bank reconciliation.
b. Pension plan contract.
c. Articles of incorporation.
d. Flowchart of the internal control procedures.

M90#24. Which of the following procedures is least likely to be performed before the balance sheet date?

a. Testing of internal control over cash.
b. Confirmation of receivables.
c. Search for unrecorded liabilities.
d. Observation of inventory.

M90#26. When auditing prepaid insurance, an auditor discovers that the original insurance policy on plant equipment is not available for inspection. The policy’s absence most likely indicates the possibility of a(an)

a. Insurance premium due but not recorded.
b. Deficiency in the coinsurance provision.
c. Lien on the plant equipment.
d. Understatement of insurance expense.

M90#8. An auditor would be most likely to identify a contingent liability by obtaining a(an)

a. Accounts payable confirmation.
b. Transfer agent confirmation.
c. Standard bank confirmation.
d. Related party transaction confirmation.

M90#7. An auditor's working papers should

a. Not be permitted to serve as a reference source for the client.
b. Not contain critical comments concerning management.
c. Show that the accounting records agree or reconcile with the financial statements.
d. Be considered the primary support for the financial statements being audited.

M90#10. When a client company does not maintain its own stock records, the auditor should obtain written confirmation from the transfer agent and registrar concerning

a. Restrictions on the payment of dividends.
b. The number of shares issued and outstanding.
c. Guarantees of preferred stock liquidation value.
d. The number of shares subject to agreements to repurchase.
Auditing

**M89#29.** Which of the following audit procedures would most likely assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern?

- a. Review compliance with the terms of debt agreements.
- b. Confirmation of accounts receivable from principal customers.
- c. Reconciliation of interest expense with debt outstanding.
- d. Confirmation of bank balances.

**M89#30.** Which of the following documentation is required for an audit in accordance with generally accepted auditing standards?

- a. An internal control questionnaire.
- c. A planning memorandum or checklist.
- d. A client representation letter.

**M89#31.** Which of the following most likely would be detected by an auditor's review of a client's sales cutoff?

- a. Unrecorded sales for the year.
- b. Lapping of year-end accounts receivable.
- c. Excessive sales discounts.
- d. Unauthorized goods returned for credit.

**M89#32.** Which of the following documentation is required for an audit in accordance with generally accepted auditing standards?

- a. An internal control questionnaire.
- c. A planning memorandum or checklist.
- d. A client representation letter.

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**M89**

*Items 36 and 37 are based on the following:*

**Miles Company**

*Bank Transfer Schedule*

*December 31, 1988*

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Bank Accounts</th>
<th>Amount</th>
<th>Date disbursed per</th>
<th>Date deposited per</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From</td>
<td>To</td>
<td>Books</td>
<td>Bank</td>
</tr>
<tr>
<td>2020</td>
<td>1st Natl.</td>
<td>Suburban</td>
<td>$32,000</td>
<td>12/31</td>
</tr>
<tr>
<td>2021</td>
<td>1st Natl.</td>
<td>Capital</td>
<td>21,000</td>
<td>12/31</td>
</tr>
<tr>
<td>3217</td>
<td>2nd State</td>
<td>Suburban</td>
<td>6,700</td>
<td>12/30</td>
</tr>
<tr>
<td>0659</td>
<td>Midtown</td>
<td>Suburban</td>
<td>5,500</td>
<td></td>
</tr>
</tbody>
</table>

36. The tick mark ♦ most likely indicates that the amount was traced to the

- a. December cash disbursements journal.
- b. Outstanding checklist of the applicable bank reconciliation.
- d. Year-end bank confirmations.

37. The tick mark ▲ most likely indicates that the amount was traced to the

- a. Deposits in transit of the applicable bank reconciliation.
- b. December cash receipts journal.
- d. Year-end bank confirmations.
N88#54. An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all
   a. Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
   b. Expenditures for property and equipment have not been charged to expense.
   c. Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
   d. Expenditures for property and equipment have been recorded in the proper period.

N88#55. For which of the following account balances are substantive tests of details least likely to be performed unless analytical review procedures indicate the need to extend detail testing?
   a. Payroll expense.
   b. Marketable securities.
   c. Research and development costs.
   d. Legal expense.

N88#56. Which of the following statements concerning working papers is incorrect?
   a. An auditor may support an opinion by other means in addition to working papers.
   b. The form of working papers should be designed to meet the circumstances of a particular engagement.
   c. An auditor’s working papers may not serve as a reference source for the client.
   d. Working papers should show that the internal accounting control system has been studied and evaluated to the degree necessary.

M88#26. Which of the following cash transfers results in a misstatement of cash at December 31, 1987?

<table>
<thead>
<tr>
<th>Transfer</th>
<th>Recorded in books</th>
<th>Paid by bank</th>
<th>Recorded in books</th>
<th>Received by bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>12/31/87</td>
<td>1/4/88</td>
<td>12/31/87</td>
<td>12/31/87</td>
</tr>
<tr>
<td>b.</td>
<td>1/4/88</td>
<td>1/5/88</td>
<td>12/31/87</td>
<td>12/31/87</td>
</tr>
<tr>
<td>c.</td>
<td>12/31/87</td>
<td>1/5/88</td>
<td>12/31/87</td>
<td>1/4/88</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.

M87#31. An audit working paper that reflects the major components of an amount reported in the financial statements is referred to as a(an)
   a. Lead schedule.
   b. Supporting schedule.
   c. Audit control account.
   d. Working trial balance.

M87#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.
Auditing

M91#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.

M91#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.

C. Other Specific Audit Topics

M90#28. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?
   a. Test data must consist of all possible valid and invalid conditions.
   b. The program tested is different from the program used throughout the year by the client.
   c. Several transactions of each type must be tested.
   d. Test data are processed by the client's computer programs under the auditor's control.

M90#29. A primary advantage of using generalized audit software packages to audit the financial statements of a client that uses an EDP system is that the auditor may
   a. Consider increasing the use of substantive tests of transactions in place of analytical procedures.
   b. Substantiate the accuracy of data through self-checking digits and hash totals.
   c. Reduce the level of required tests of controls to a relatively small amount.
   d. Access information stored on computer files while having a limited understanding of the client's hardware and software features.

M90#30. Stratified mean per unit (MPU) sampling is a statistical technique that may be more efficient than unstratified MPU because it usually
   a. May be applied to populations where many monetary errors are expected to occur.
   b. Produces an estimate having a desired level of precision with a smaller sample size.
   c. Increases the variability among items in a stratum by grouping sampling units with similar characteristics.
   d. Yields a weighted sum of the strata standard deviations that is greater than the standard deviation of the population.
Selected Questions

N90#31. An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to
   a. Eliminate the risk of nonsampling errors.
   b. Reduce the level of audit risk and materiality to a relatively low amount.
   c. Measure the sufficiency of the evidential matter obtained.
   d. Minimize the failure to detect errors and irregularities.

N90#32. Which of the following events most likely indicates the existence of related parties?
   a. Borrowing a large sum of money at a variable rate of interest.
   b. Selling real estate at a price that differs significantly from its book value.
   c. Making a loan without scheduled terms for repayment of the funds.
   d. Discussing merger terms with a company that is a major competitor.

N90#33. Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?
   a. Review the cut-off bank statements for the period after the year-end.
   b. Inquire of the client's legal counsel concerning litigation.
   c. Investigate reportable conditions previously communicated to the client.
   d. Analyze related party transactions to discover possible irregularities.

N90#34. Because of the pervasive effects of laws and regulations on the financial statements of governmental units, an auditor should obtain written management representations acknowledging that management has
   a. Implemented internal control policies and procedures designed to detect all illegal acts.
   b. Documented the procedures performed to evaluate the governmental unit's compliance with laws and regulations.
   c. Identified and disclosed all laws and regulations that have a direct and material effect on its financial statements.
   d. Reported all known illegal acts and material weaknesses in internal control structure to the funding agency or regulatory body.

N90#35. Six months after issuing an unqualified opinion on audited financial statements, an auditor discovered that the engagement personnel failed to confirm several of the client's material accounts receivable balances. The auditor should first
   a. Request the permission of the client to undertake the confirmation of accounts receivable.
   b. Perform alternative procedures to provide a satisfactory basis for the unqualified opinion.
   c. Assess the importance of the omitted procedures to the auditor's ability to support the previously expressed opinion.
   d. Inquire whether there are persons currently relying, or likely to rely, on the unqualified opinion.

N90#36. Processing data through the use of simulated files provides an auditor with information about the operating effectiveness of control policies and procedures. One of the techniques involved in this approach makes use of
   a. Input validation.
   b. Program code checking.
   c. Controlled reprocessing.
   d. Integrated test facility.

N90#37. An auditor would be most likely to consider modifying an otherwise unqualified opinion if the client's financial statements include a footnote on related party transactions
   a. Representing that certain related party transactions were consummated on terms equivalent to those obtainable in transactions with unrelated parties.
   b. Presenting the dollar volume of related party transactions and the effects of any change in the method of establishing terms from that used in the prior period.
   c. Explaining the business purpose of the sale of real property to a related party.
   d. Disclosing compensating balance arrangements maintained for the benefit of related parties.

N90#38. When an accounting application is processed by computer, an auditor can not verify the reliable operation of programmed control procedures by
   a. Manually comparing detail transaction files used by an edit program to the program's generated error listings to determine that errors were properly identified by the edit program.
   b. Constructing a processing system for accounting applications and processing actual data from throughout the period through both the client's program and the auditor's program.
   c. Manually reperforming, as of a point in time, the processing of input data and comparing the simulated results to the actual results.
   d. Periodically submitting auditor-prepared test data to the same computer process and evaluating the results.
Auditing

N89#32. To obtain evidence that user identification and password controls are functioning as designed, an auditor would most likely
   a. Attempt to sign-on to the system using invalid user identifications and passwords.
   b. Write a computer program that simulates the logic of the client's access control software.
   c. Extract a random sample of processed transactions and ensure that the transactions were appropriately authorized.
   d. Examine statements signed by employees stating that they have not divulged their user identifications and passwords to any other person.

N89#33. While performing a substantive test of details during an audit, the auditor determined that the sample results supported the conclusion that the recorded account balance was materially misstated. It was, in fact, not materially misstated. This situation illustrates the risk of
   a. Incorrect rejection.
   b. Incorrect acceptance.
   c. Overreliance.
   d. Underreliance.

N89#34. Which of the following would be designed to estimate a numerical measurement of a population, such as a dollar value?
   a. Sampling for variables.
   b. Sampling for attributes.
   c. Discovery sampling.
   d. Numerical sampling.

N89#35. Which of the following is not a major reason why an accounting audit trail should be maintained for a computer system?
   a. Monitoring purposes.
   b. Analytical procedures.
   c. Query answering.
   d. Deterrent to irregularities.

N89#36. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?
   a. Parallel simulation.
   b. Generalized audit software programming.
   c. Integrated test facility.
   d. Test data approach.

N89#37. In a probability-proportional-to-size sample with a sampling interval of $10,000, an auditor discovered that a selected account receivable with a recorded amount of $5,000 had an audit amount of $2,000. The projected error of this sample was
   a. $3,000.
   b. $4,000.
   c. $6,000.
   d. $8,000.

N89#41. An auditor is performing substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items. Past experience indicates numerous pricing and extension errors. Which of the following statistical sampling approaches is most appropriate?
   a. Unstratified mean-per-unit.
   c. Stop or go.
   d. Ratio estimation.

N89#42. An auditor searching for related party transactions should obtain an understanding of each subsidiary's relationship to the total entity because
   a. This may permit the audit of intercompany account balances to be performed as of concurrent dates.
   b. Intercompany transactions may have been consummated on terms equivalent to arm's-length transactions.
   c. This may reveal whether particular transactions would have taken place if the parties had not been related.
   d. The business structure may be deliberately designed to obscure related party transactions.

N89#43. A typical objective of an operational audit is to determine whether an entity's
   a. Internal control structure is adequately operating as designed.
   b. Operational information is in accordance with generally accepted governmental auditing standards.
   c. Financial statements present fairly the results of operations.
   d. Specific operating units are functioning efficiently and effectively.

N89#44. An auditor concludes that the omission of a substantive procedure considered necessary at the time of the examination may impair the auditor's present ability to support the previously expressed opinion. The auditor need not apply the omitted procedure if
   a. The risk of adverse publicity or litigation is low.
   b. The results of other procedures that were applied tend to compensate for the procedure omitted.
   c. The auditor's opinion was qualified because of a departure from generally accepted accounting principles.
   d. The results of the subsequent period's tests of controls make the omitted procedure less important.
Selected Questions

M88#37. 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.

M88 Item 59 is based on the following flowchart:

![Flowchart]

59. The above flowchart depicts
   a. Program code checking.
   b. Parallel simulation.
   c. Integrated test facility.
   d. Controlled reprocessing.

M88#17. Using microcomputers in auditing may affect the methods used to review the work of staff assistants because
   a. Supervisory personnel may not have an understanding of the capabilities and limitations of microcomputers.
   b. Working paper documentation may not contain readily observable details of calculations.
   c. The audit field work standards for supervision may differ.
   d. Documentation of the supervisory review may require assistance of management services personnel.

M88#33. A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?
   a. Greater reliance on internal accounting controls.
   b. Greater reliance on analytical review procedures.
   c. Smaller expected frequency of errors.
   d. Smaller measure of tolerable error.

M88#34. Which of the following statements is correct concerning the auditor’s use of statistical sampling?
   a. An auditor needs to estimate the dollar amount of the standard deviation of the population to use classical variables sampling.
   b. An assumption of PPS sampling is that the underlying accounting population is normally distributed.
   c. A classical variables sample needs to be designed with special considerations to include negative balances in the sample.
   d. The selection of zero balances usually does not require special sample design considerations when using PPS sampling.

M88#35. Which of the following statements is correct concerning related party transactions?
   a. In the absence of evidence to the contrary, related party transactions should be assumed to be outside the ordinary course of business.
   b. An auditor should determine whether a particular transaction would have occurred if the parties had not been related.
   c. An auditor should substantiate that related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.
   d. The audit procedures directed toward identifying related party transactions should include considering whether transactions are occurring, but are not being given proper accounting recognition.

M88#36. Ajax Company's auditor concludes that the omission of an audit procedure considered necessary at the time of the prior examination impairs the auditor's present ability to support the previously expressed unqualified opinion. If the auditor believes there are stockholders currently relying on the opinion, the auditor should promptly
   a. Notify the stockholders currently relying on the previously expressed unqualified opinion that they should not rely on it.
   b. Advise management to disclose this development in its next interim report to the stockholders.
   c. Advise management to revise the financial statements with full disclosure of the auditor's inability to support the unqualified opinion.
   d. Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.
M88#37. A governmental audit may extend beyond an examination leading to the expression of an opinion on the fairness of financial presentation to include

<table>
<thead>
<tr>
<th>Program results</th>
<th>Compliance</th>
<th>Economy &amp; efficiency</th>
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<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>
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</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.
d. Obtain a letter from the entity's attorney describing any pending litigation, unasserted claims, or loss contingencies.

M87#6. An auditor who is determining the scope of work to be performed concerning possible related party transactions should

a. Assume that transactions with related parties are outside the ordinary course of business.
b. Determine whether transactions with related parties would have taken place if the parties had not been related.
c. Obtain an understanding of management responsibilities and the relationship of each of the parties to the total entity.
d. Establish a basis of accounting principles different from that which would have been appropriate had the parties not been related.

M87#38. Hill has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar- unit sampling, in the audit of a client's accounts receivable balances. Hill plans to use the following PPS sampling table:

<table>
<thead>
<tr>
<th>Number of overstatement errors</th>
<th>Risk of incorrect acceptance</th>
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</thead>
<tbody>
<tr>
<td>1%</td>
<td>5%</td>
</tr>
<tr>
<td>1</td>
<td>2.31</td>
</tr>
<tr>
<td>2</td>
<td>5.33</td>
</tr>
<tr>
<td>3</td>
<td>8.00</td>
</tr>
<tr>
<td>4</td>
<td>11.61</td>
</tr>
</tbody>
</table>

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#39. Operational auditing is primarily oriented toward

a. Future improvements to accomplish the goals of management.
b. The accuracy of data reflected in management's financial records.
c. The verification that a company's financial statements are fairly presented.
d. Past protection provided by existing internal accounting control.

M87#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.

Tolerable error
(net of effect of expected error) $ 24,000
Risk of incorrect acceptance 20%
Number of errors allowed 1
Recorded amount of accounts receivable $240,000
Number of accounts .560

What sample size should Hill use?

a. 120
b. 108
c. 60
d. 30
Selected Questions

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.

D. Review and Compilation Procedures

M91#19. When compiling a nonpublic entity’s financial statements, an accountant would be least likely to
   a. Perform analytical procedures designed to identify relationships that appear to be unusual.
   b. Read the compiled financial statements and consider whether they appear to include adequate disclosure.
   c. Omit substantially all of the disclosures required by generally accepted accounting principles.
   d. Issue a compilation report on one or more, but not all, of the basic financial statements.

M91#20. Which of the following procedures would most likely be included in a review engagement of a nonpublic entity?
   a. Preparing a bank transfer schedule.
   b. Inquiring about related party transactions.
   c. Assessing the internal control structure.
   d. Performing cutoff tests on sales and purchases transactions.

M90#4. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity’s financial statements include
   a. Inquiries concerning actions taken at meetings of the stockholders and the board of directors.
   b. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
   c. Inquiries designed to identify reportable conditions in the internal control structure.
   d. Analytical procedures concerning management’s assertions regarding continued existence.

M89#35. Before performing a review of a nonpublic entity’s financial statements, an accountant should
   a. Complete a series of inquiries concerning the entity’s procedures for recording, classifying, and summarizing transactions.

b. Apply analytical procedures to provide limited assurance that no material modifications should be made to the financial statements.
   c. Obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates.
   d. Inquire whether management has omitted substantially all of the disclosures required by generally accepted accounting principles.

M89#45. One of the conditions required for an accountant to submit a written personal financial plan containing unaudited financial statements to a client without complying with the requirements of SSARS 1 (Compilation and Review of Financial Statements) is that the
   a. Client agrees that the financial statements will not be used to obtain credit.
   b. Accountant compiled or reviewed the client’s financial statements for the immediate prior year.
   c. Engagement letter acknowledges that the financial statements will contain departures from generally accepted accounting principles.
   d. Accountant expresses limited assurance that the financial statements are free of any material misstatements.

M88#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.
Auditing

M87#41. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity's financial statements include

a. Analytical procedures designed to identify material weaknesses in internal accounting control.

b. Inquiries concerning actions taken at meetings of the stockholders and the board of directors.

c. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.

d. Inquiries of knowledgeable outside parties such as the client's attorneys and bankers.

M87#34. Prior to commencing the compilation of financial statements of a nonpublic entity, the accountant should

a. Perform analytical review procedures sufficient to determine whether fluctuations among account balances appear reasonable.

b. Complete the preliminary phase of the study and evaluation of the entity's internal accounting control.

c. Verify that the financial information supplied by the entity agrees with the books of original entry.

d. Acquire a knowledge of any specialized accounting principles and practices used in the entity's industry.

M87#35. Which of the following would the accountant most likely investigate during the review of financial statements of a nonpublic entity if accounts receivable did not conform to a predictable pattern during the year?

a. Sales returns and allowances.

b. Credit sales.

c. Sales of consigned goods.

d. Cash sales.

IV. Reporting

A. Reporting Standards and Types of Reports

M91#38. Green, CPA, is aware that Green's name is to be included in the interim report of National Company, a publicly-held entity. National's quarterly financial statements are contained in the interim report. Green has not audited or reviewed these interim financial statements. Green should request that

I. Green's name not be included in the communication.

II. The financial statements be marked as unaudited with a notation that no opinion is expressed on them.

a. I only.

b. II only.

c. Both I and II.

d. Either I or II.

M91#41. An accountant's standard report on a compilation of a projection should not include a

a. Statement that the accountant expresses only limited assurance that the results may be achieved.

b. Separate paragraph that describes the limitations on the presentation's usefulness.

c. Statement that a compilation of a projection is limited in scope.

d. Disclaimer of responsibility to update the report for events occurring after the report's date.

M91#42. An auditor was unable to obtain audited financial statements or other evidence supporting an entity's investment in a foreign subsidiary. Between which of the following opinions should the entity's auditor choose?

a. Adverse and unqualified with an explanatory paragraph added.

b. Disclaimer and unqualified with an explanatory paragraph added.

c. Qualified and adverse.

d. Qualified and disclaimer.

M91#43. The adverse effects of events causing an auditor to believe there is substantial doubt about an entity's ability to continue as a going concern would most likely be mitigated by evidence relating to the

a. Ability to expand operations into new product lines in the future.

b. Feasibility of plans to purchase leased equipment at less than market value.

c. Marketability of assets that management plans to sell.

d. Committed arrangements to convert preferred stock to long-term debt.

M91#44. If an auditor is satisfied that there is only a remote likelihood of a loss resulting from the resolution
Selected Questions

of a matter involving an uncertainty, the auditor should express a(an)

a. Unqualified opinion.
b. Unqualified opinion with a separate explanatory paragraph.
c. Qualified opinion or disclaimer of opinion, depending upon the materiality of the loss.
d. Qualified opinion or disclaimer of opinion, depending on whether the uncertainty is adequately disclosed.

M91#45. When an auditor qualifies an opinion because of the inability to confirm accounts receivable by direct communication with debtors, the wording of the opinion paragraph of the auditor's report should indicate that the qualification pertains to the

a. Limitation on the auditor's scope.
b. Possible effects on the financial statements.
c. Lack of sufficient competent evidential matter.
d. Departure from generally accepted auditing standards.

M91#46. When an auditor qualifies an opinion because of inadequate disclosure, the auditor should describe the nature of the omission in a separate explanatory paragraph and modify the

<table>
<thead>
<tr>
<th>Introductory paragraph</th>
<th>Scope paragraph</th>
<th>Opinion paragraph</th>
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<tr>
<td>a. Yes</td>
<td>No</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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M91#48. An auditor includes a separate paragraph in an otherwise unmodified report to emphasize that the entity being reported upon had significant transactions with related parties. The inclusion of this separate paragraph

a. Is appropriate and would not negate the unqualified opinion.
b. Is considered an “except for” qualification of the opinion.
c. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
d. Necessitates a revision of the opinion paragraph to include the phrase “with the foregoing explanation.”

M91#49. The financial statements of KCP America, a U.S. entity, are prepared for inclusion in the consolidated financial statements of its non-U.S. parent. These financial statements are prepared in conformity with the accounting principles generally accepted in the parent country and are for use only in that country. How may KCP America's auditor report on these financial statements?

I. A U.S.-style report (unmodified).
II. A U.S.-style report modified to report on the accounting principles of the parent country.
III. The report form of the parent country.

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<th>I</th>
<th>II</th>
<th>III</th>
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<tbody>
<tr>
<td>a. Yes</td>
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<td>c. Yes</td>
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<td>d. No</td>
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M91#50. Compiled financial statements should be accompanied by a report stating that

a. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
b. The accountant has compiled the financial statements in accordance with standards established by the Auditing Standards Board.
c. A compilation is substantially less in scope than a review or an audit in accordance with generally accepted auditing standards.
d. The accountant does not express an opinion but expresses only limited assurance on the compiled financial statements.

M91#53. An auditor most likely would issue a disclaimer of opinion because of

a. Inadequate disclosure of material information.
b. The omission of the statement of cash flows.
c. A material departure from generally accepted accounting principles.
d. Management's refusal to furnish written representations.

M91#55. Performing inquiry and analytical procedures is the primary basis for an accountant to issue a report on compliance with requirements governing major federal assistance programs in accordance with the Single Audit Act.

a. Report on compliance with requirements governing major federal assistance programs in accordance with the Single Audit Act.
b. Review report on prospective financial statements that present an entity's expected financial position, given one or more hypothetical assumptions.
c. Management advisory report prepared at the request of a client's audit committee.
d. Review report on comparative financial statements for a nonpublic entity in its second year of operations.

M91#60. Kent is auditing an entity's compliance with requirements governing a major federal financial assistance program in accordance with the Single Audit Act. Kent detected noncompliance with requirements that have a material effect on that program. Kent's report on compliance should express a(an)

a. Unqualified opinion with a separate explanatory paragraph.
b. Qualified opinion or an adverse opinion.
c. Adverse opinion or a disclaimer of opinion.
d. Limited assurance on the items tested.
Auditing

N90#1. Baker, CPA, was engaged to review the financial statements of Hall Company, a nonpublic entity. Evidence came to Baker's attention that indicated substantial doubt as to Hall's ability to continue as a going concern. The principal conditions and events that caused the substantial doubt have been fully disclosed in the notes to Hall's financial statements. Which of the following statements best describes Baker's reporting responsibility concerning this matter?

a. Baker is not required to modify the accountant's review report.
b. Baker is not permitted to modify the accountant's review report.
c. Baker should issue an accountant's compilation report instead of a review report.
d. Baker should express a qualified opinion in the accountant's review report.

N90#2. King, CPA, was engaged to audit the financial statements of Newton Company after its fiscal year had ended. King neither observed the inventory count nor confirmed the receivables by direct communication with debtors, but was satisfied concerning both after applying alternative procedures. King's auditor's report most likely contained a(an)

a. Qualified opinion.
b. Disclaimer of opinion.
c. Unqualified opinion.
d. Unqualified opinion with an explanatory paragraph.

N90#3. In which of the following circumstances would an auditor be most likely to express an adverse opinion?

a. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue as a going concern.
b. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.
c. Tests of controls show that the entity's internal control structure is so poor that it cannot be relied upon.
d. The financial statements are not in conformity with the FASB Statements regarding the capitalization of leases.

N90#4. It is not appropriate to refer a reader of an auditor's report to a financial statement footnote for details concerning

a. Subsequent events.
b. The pro forma effects of a business combination.
c. Sale of a discontinued operation.
d. The results of confirmation of receivables.

N90#5. Tech Company has disclosed an uncertainty due to pending litigation. The auditor's decision to issue a qualified opinion rather than an unqualified opinion with an explanatory paragraph most likely would be determined by the

a. Lack of sufficient evidence.
b. Inability to estimate the amount of loss.
c. Entity's lack of experience with such litigation.
d. Lack of insurance coverage for possible losses from such litigation.

N90#6. In which of the following situations would an auditor ordinarily issue an unqualified audit opinion without an explanatory paragraph?

a. The auditor wishes to emphasize that the entity had significant related party transactions.
b. The auditor decides to make reference to the report of another auditor as a basis, in part, for the auditor's opinion.
c. The entity issues financial statements that present financial position and results of operations, but omits the statement of cash flows.
d. The auditor has substantial doubt about the entity's ability to continue as a going concern, but the circumstances are fully disclosed in the financial statements.

N90#7. The fourth standard of reporting requires the auditor's report to contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent

a. Misinterpretations regarding the degree of responsibility the auditor is assuming.
b. An auditor from reporting on one basic financial statement and not the others.
c. An auditor from expressing different opinions on each of the basic financial statements.
d. Restrictions on the scope of the examination, whether imposed by the client, or by the inability to obtain evidence.

N90#8. When there has been a change in accounting principle that materially affects the comparability of the comparative financial statements presented and the auditor concurs with the change, the auditor should

<table>
<thead>
<tr>
<th>Concur explicitly with the change</th>
<th>Issue an &quot;except for&quot; qualified opinion</th>
<th>Refer to the change in an explanatory paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>No</td>
<td>No</td>
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<tr>
<td>b.</td>
<td>Yes</td>
<td>No</td>
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<td>c.</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
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</table>


A-42
Selected Questions

**N90#9.** Accepting an engagement to compile a financial projection for a publicly held company most likely would be inappropriate if the projection were to be distributed to

a. A bank with which the entity is negotiating for a loan.
b. A labor union with which the entity is negotiating a contract.
c. The principal stockholder, to the exclusion of the other stockholders.
d. All stockholders of record as of the report date.

c. Qualified and describe the departure in a separate paragraph.
d. Qualified or adverse, depending on materiality, and describe the departure in a separate paragraph.

**N90#10.** Comparative financial statements include the prior year's statements that were audited by a predecessor auditor whose report is not presented. If the predecessor's report was unqualified, the successor should

a. Express an opinion on the current year's statements alone and make no reference to the prior year's statements.
b. Indicate in the auditor's report that the predecessor auditor expressed an unqualified opinion.
c. Obtain a letter of representations from the predecessor concerning any matters that might affect the successor's opinion.
d. Request the predecessor auditor to reissue the prior year's report.

**N90#11.** When reporting on comparative financial statements, which of the following circumstances ordinarily should cause the auditor to change the previously issued opinion on the prior year's financial statements?

a. The prior year's financial statements are restated following a pooling of interests in the current year.
b. A departure from generally accepted accounting principles caused an adverse opinion on the prior year's financial statements and those statements have been properly restated.
c. A change in accounting principle caused the auditor to make a consistency modification in the current year's auditor's report.
d. A scope limitation caused a qualified opinion on the prior year's financial statements but the current year's opinion was properly unqualified.

c. Qualified opinion or a disclaimer of opinion.
d. Disclaimer of opinion or an unqualified opinion with an explanatory paragraph.

d. An opinion as to whether the basis of accounting used is appropriate under the circumstances.

d. A statement that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

**N90#14.** Tread Corp. accounts for the effect of a material accounting change prospectively when the inclusion of the cumulative effect of the change is required in the current year. The auditor would choose between expressing a(an)

a. Qualified opinion or a disclaimer of opinion.
b. Disclaimer of opinion or an unqualified opinion with an explanatory paragraph.
c. Unqualified opinion with an explanatory paragraph and an adverse opinion.
d. Adverse opinion and a qualified opinion.

**N90#12.** Eagle Company's financial statements contain a departure from generally accepted accounting principles because, due to unusual circumstances, the statements would otherwise be misleading. The auditor should express an opinion that is

a. Unqualified but not mention the departure in the auditor's report.
b. Unqualified and describe the departure in a separate paragraph.

c. Interim financial information of a publicly held company that is subject to a limited review.

c. Compliance with aspects of regulatory requirements related to audited financial statements.

c. Application of accounting principles to specified transactions.

d. Limited use prospective financial statements such as a financial projection.

**N90#12.** An explanatory paragraph following the opinion paragraph of an auditor's report describes an uncertainty as follows:

As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming damages. Discovery proceedings are in progress. The ultimate outcome of the litigation cannot presently be
determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

What type of opinion should the auditor express under these circumstances?
   a. Unqualified.
   b. "Subject to" qualified.
   c. "Except for" qualified.
   d. Disclaimer.

M90#13. The predecessor auditor, who is satisfied after properly communicating with the successor auditor, has reissued a report because the audit client desires comparative financial statements. The predecessor auditor’s report should make
   a. Reference to the report of the successor auditor only in the scope paragraph.
   b. Reference to the work of the successor auditor in the scope and opinion paragraphs.
   c. Reference to both the work and the report of the successor auditor only in the opinion paragraph.
   d. No reference to the report or the work of the successor auditor.

M90#14. If a publicly held company issues financial statements that purport to present its financial position and results of operations but omits the statement of cash flows, the auditor ordinarily will express an expository paragraph.
   a. Unqualified opinion with a separate explanatory paragraph.
   b. Disclaimer of opinion.
   c. Adverse opinion.
   d. Qualified opinion.

M90#15. An auditor’s report that refers to the use of an accounting principle at variance with generally accepted accounting principles contains the words, “In our opinion, with the foregoing explanation, the financial statements referred to above present fairly...”. This is considered an
   a. Adverse opinion.
   b. “Except for” qualified opinion.
   c. Unqualified opinion with an explanatory paragraph.
   d. Example of inappropriate reporting.

M90#16. In which of the following circumstances would an auditor usually choose between issuing a qualified opinion or a disclaimer of opinion?
   a. Departure from generally accepted accounting principles.
   b. Inadequate disclosure of accounting policies.
   c. Inability to obtain sufficient competent evidential matter.
   d. Unreasonable justification for a change in accounting principle.

M90#17. An auditor has previously expressed a qualified opinion on the financial statements of a prior period because of a departure from generally accepted accounting principles. The prior-period financial statements are restated in the current period to conform with generally accepted accounting principles. The auditor’s updated report on the prior-period financial statements should
   a. Express an unqualified opinion concerning the restated financial statements.
   b. Be accompanied by the original auditor’s report on the prior period.
   c. Bear the same date as the original auditor’s report on the prior period.
   d. Qualify the opinion concerning the restated financial statements because of a change in accounting principle.

M90#18. Under which of the following circumstances would a disclaimer of opinion not be appropriate?
   a. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
   b. The auditor is unable to determine the amounts associated with illegal acts committed by the client’s management.
   c. The financial statements fail to contain adequate disclosure concerning related party transactions.
   d. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.

M90#19. During a review of the financial statements of a nonpublic entity, an accountant becomes aware of a lack of adequate disclosure that is material to the financial statements. If management refuses to correct the financial statement presentations, the accountant should
   a. Issue an adverse opinion.
   b. Issue an “except for” qualified opinion.
   c. Disclose this departure from generally accepted accounting principles in a separate paragraph of the report.
   d. Express only limited assurance on the financial statement presentations.

M90#20. Before issuing a report on the compilation of financial statements of a nonpublic entity, the accountant should
   a. Apply analytical procedures to selected financial data to discover any material misstatements.
   b. Corroborate at least a sample of the assertions management has embodied in the financial statements.
   c. Inquire of the client’s personnel whether the financial statements omit substantially all disclosures.
   d. Read the financial statements to consider whether the financial statements are free from obvious material errors.
**Selected Questions**

**N89#21.** When reporting on financial statements prepared on the same basis of accounting used for income tax purposes, the auditor should include in the report a paragraph that

a. Emphasizes that the financial statements are not intended to have been examined in accordance with generally accepted auditing standards.

b. Refers to the authoritative pronouncements that explain the income tax basis of accounting being used.

c. States that the income tax basis of accounting is a comprehensive basis of accounting other than generally accepted accounting principles.

d. Justifies the use of the income tax basis of accounting.

**N89#22.** When a qualified opinion results from a limitation on the scope of the audit, the situation should be described in an explanatory paragraph

a. Preceding the opinion paragraph and referred to only in the scope paragraph of the auditor’s report.

b. Following the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor’s report.

c. Following the opinion paragraph and referred to only in the scope paragraph of the auditor’s report.

d. Preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor’s report.

**N89#23.** Which of the following statements concerning prospective financial statements is correct?

a. Only a financial forecast would normally be appropriate for limited use.

b. Only a financial projection would normally be appropriate for general use.

c. Any type of prospective financial statements would normally be appropriate for limited use.

d. Any type of prospective financial statements would normally be appropriate for general use.

**N89#2.** When there is a significant change in accounting principle, an auditor’s report should refer to the lack of consistency in

a. The scope paragraph.

b. An explanatory paragraph between the second paragraph and the opinion paragraph.

c. The opinion paragraph.

d. An explanatory paragraph following the opinion paragraph.

**N89#3.** How are management’s responsibility and the auditor’s responsibility represented in the standard auditor’s report?

<table>
<thead>
<tr>
<th>Management’s responsibility</th>
<th>Auditor’s responsibility</th>
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<td>a. Explicitly</td>
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<td>c. Implicitly</td>
<td>Explicitly</td>
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<td>d. Explicitly</td>
<td>Implicitly</td>
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**N89#4.** Restrictions imposed by a client prohibit the observation of physical inventories, which account for 35% of all assets. Alternative audit procedures cannot be applied, although the auditor was able to examine satisfactory evidence for all other items in the financial statements. The auditor should issue a(an)

a. “Except for” qualified opinion.

b. Disclaimer of opinion.

c. Unqualified opinion with a separate explanatory paragraph.

d. Unqualified opinion with an explanation in the scope paragraph.

**N89#5.** When an accountant performs more than one level of service (for example, a compilation and a review, or a compilation and an audit) concerning the financial statements of a nonpublic entity, the accountant generally should issue the report that is appropriate for

a. The lowest level of service rendered.

b. The highest level of service rendered.

c. A compilation engagement.

d. A review engagement.

**N89#6.** An accountant who reviews the financial statements of a nonpublic entity should issue a report stating that a review

a. Is substantially less in scope than an audit.

b. Provides negative assurance that the internal control structure is functioning as designed.

c. Provides only limited assurance that the financial statements are fairly presented.

d. Is substantially more in scope than a compilation.

**N89#7.** A limitation on the scope of an auditor’s examination sufficient to preclude an unqualified opinion will usually result when management

a. Presents financial statements that are prepared in accordance with the cash receipts and disbursements basis of accounting.

b. States that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.

c. Does not make the minutes of the Board of Directors’ meetings available to the auditor.

d. Asks the auditor to report on the balance sheet and not on the other basic financial statements.
Auditing

N89#8. Grant Company's financial statements adequately disclose uncertainties that concern future events, the outcome of which are not susceptible of reasonable estimation. The auditor's report should include a(a)

1. Unqualified opinion.
2. "Subject to" qualified opinion.
3. "Except for" qualified opinion.
4. Adverse opinion.

N89#9. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. If the entity's disclosures concerning this matter are adequate, the audit report may include a(a)

<table>
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<tr>
<th>Disclaimer of opinion</th>
<th>&quot;Except for&quot; qualified opinion</th>
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<tr>
<td>a. Yes</td>
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<td>b. No</td>
<td>No</td>
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<td>c. No</td>
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<td>d. Yes</td>
<td>No</td>
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</table>

N89#10. An auditor may issue a qualified opinion under which of the following circumstances?

<table>
<thead>
<tr>
<th>Lack of sufficient competent evidential matter</th>
<th>Restrictions on the scope of the audit</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. Yes</td>
<td>No</td>
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<td>c. No</td>
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<td>d. No</td>
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N89#11. When reporting on comparative financial statements, an auditor ordinarily should change the previously issued opinion on the prior year's financial statements if

1. The prior year's opinion was unqualified and the opinion on the current year's financial statements is modified due to a lack of consistency.
2. The prior year's financial statements are restated following a pooling of interests in the current year.
3. The prior year's financial statements are restated to conform with generally accepted accounting principles.
4. The auditor is a predecessor auditor who has been requested by a former client to reissue the previously issued report.

N89#12. Does an auditor make the following representations explicitly or implicitly when issuing the standard auditor's report on comparative financial statements?

Consistent application of accounting principles | Examination of evidence on a test basis

| a. Explicitly | a. Explicitly |
| b. Implicitly | b. Implicitly |
| c. Implicitly | c. Implicitly |
| d. Explicitly | d. Implicitly |

N89#13. An auditor should disclose the substantive reasons for expressing an adverse opinion in an explanatory paragraph

1. Preceding the scope paragraph.
2. Preceding the opinion paragraph.
3. Following the opinion paragraph.
4. Within the notes to the financial statements.

N89#14. When management does not provide reasonable justification that a change in accounting principle is preferable and it presents comparative financial statements, the auditor should express a qualified opinion

1. Only in the year of the accounting principle change.
2. Each year that the financial statements initially reflecting the change are presented.
3. Each year until management changes back to the accounting principle formerly used.
4. Only if the change is to an accounting principle that is not generally accepted.

N89#15. When an accountant compiles a nonpublic entity's financial statements that omit substantially all disclosures required by generally accepted accounting principles, the accountant should indicate in the compilation report that the financial statements are

1. Restricted for internal use only by the entity's management.
2. Not to be given to financial institutions for the purpose of obtaining credit.
3. Compiled in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.
4. Not designed for those who are uninformed about the omitted disclosures.

N89#16. When an independent CPA is associated with the financial statements of a publicly held entity but has not audited or reviewed such statements, the appropriate form of report to be issued must include a(a)

1. Compilation report.
2. Disclaimer of opinion.
3. Unaudited association report.
4. Qualified opinion.

N89#17. The objective of a review of interim financial information is to provide an accountant with a basis for reporting whether

1. The financial statements are presented fairly in accordance with generally accepted accounting principles.
b. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
c. Material modifications should be made to conform with generally accepted accounting principles.
d. The financial statements are presented fairly in accordance with standards of interim reporting.

N89#18. When an auditor is requested to express an opinion on the rental and royalty income of an entity, the auditor may
a. Not accept the engagement because to do so would be tantamount to agreeing to issue a piecemeal opinion.
b. Not accept the engagement unless also engaged to audit the full financial statements of the entity.
c. Accept the engagement provided the auditor's opinion is expressed in a special report.
d. Accept the engagement provided distribution of the auditor's report is limited to the entity's management.

N89#19. Negative assurance may be expressed when an accountant is requested to report on the
a. Compilation of prospective financial statements.
b. Compliance with the provisions of the Foreign Corrupt Practices Act.
c. Results of applying agreed-upon procedures to an account within unaudited financial statements.
d. Audit of historical financial statements.

N89#20. When an accountant compiles projected financial statements, the accountant's report should include a separate paragraph that
a. Describes the differences between a projection and a forecast.
b. Identifies the accounting principles used by management.
c. Expresses limited assurance that the actual results may be within the projection's range.
d. Describes the limitations on the projection's usefulness.

N89#21. When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant's report and issue a(an)
a. "Except for" qualified opinion.
b. "Subject to" qualified opinion.
c. Unqualified opinion with a separate explanatory paragraph.
d. Adverse opinion.

N89#22. Soon after Boyd's audit report was issued, Boyd learned of certain related party transactions that occurred during the year under audit. These transactions were not disclosed in the notes to the financial statements. Boyd should
a. Plan to audit the transactions during the next engagement.
b. Recall all copies of the audited financial statements.
c. Determine whether the lack of disclosure would affect the auditor's report.
d. Ask the client to disclose the transactions in subsequent interim statements.

N89#24. Management of Hill Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor's report should include a separate explanatory paragraph and contain a(an)
a. "Except for" qualified opinion.
b. "Subject to" qualified opinion.
c. Adverse opinion.
d. Unqualified opinion.

N89#46. A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will always result when management
a. Engages the auditor after the year-end physical inventory count is completed.
b. Fails to correct a material internal control weakness that had been identified during the prior year's audit.
c. Refuses to furnish a management representation letter to the auditor.
d. Prevents the auditor from reviewing the working papers of the predecessor auditor.

N89#47. An accountant has been asked to compile the financial statements of a nonpublic company on a prescribed form that omits substantially all the disclosures required by generally accepted accounting principles. If the prescribed form is a standard preprinted form adopted by the company's industry trade association, and is to be transmitted only to such association, the accountant
a. Need not advise the industry trade association of the omission of all disclosures.
b. Should disclose the details of the omissions in separate paragraphs of the compilation report.
c. Is precluded from issuing a compilation report when all disclosures are omitted.
d. Should express limited assurance that the financial statements are free of material misstatements.

N89#48. On September 30, 1988, Miller was asked to reissue an auditor's report, dated March 31, 1988, on a client's financial statements for the year ended December 31, 1987. Miller will submit the reissued report
to the client in a document that contains information in addition to the client's basic financial statements. However, Miller discovered that the client suffered substantial losses on receivables resulting from conditions that occurred since March 31, 1988. Miller should

a. Request the client to disclose the event in a separate, appropriately labeled note to the financial statements and reissue the original report with its original date.

b. Request the client to restate the financial statements and reissue the original report with a dual date.

c. Reissue the original report with its original date without regard to whether the event is disclosed in a separate note to the financial statements.

d. Not reissue the original report but issue a "subject to" qualified opinion that discloses the event in a separate explanatory paragraph.

M89#54. Unaudited financial statements for the prior year presented in comparative form with audited financial statements for the current year should be clearly marked to indicate their status and

I. The report on the prior period should be reissued to accompany the current period report.

II. The report on the current period should include as a separate paragraph a description of the responsibility assumed for the prior period's financial statements.

a. I only.

b. II only.

c. Both I and II.

d. Either I or II.

M89#55. When a publicly-held company refuses to include in its audited financial statements any of the segment information that the auditor believes is required, the auditor should issue a(an)

a. Unqualified opinion with a separate explanatory paragraph emphasizing the matter.

b. "Except for" qualified opinion because of inadequate disclosure.

c. Adverse opinion because of the lack of conformity with generally accepted accounting principles.

d. Disclaimer of opinion because of the significant scope limitation.

M89#56. Green Company uses the first-in, first-out method of costing for its international subsidiary's inventory and the last-in, first-out method of costing for its domestic inventory. The different costing methods would cause Green's auditor to issue a report with an

a. Explanatory paragraph as to consistency.

b. "Except for" qualified opinion.

c. Opinion modified as to consistency.

d. Unqualified opinion.
Selected Questions

M88#58. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that
a. Distribution of the report is to be restricted to the specified users involved.
b. The prospective financial statements are also examined.
c. Responsibility for the adequacy of the procedures performed is taken by the accountant.
d. Negative assurance is expressed on the prospective financial statements taken as a whole.

M88#59. When a client will not permit inquiry of outside legal counsel, the audit report will ordinarily contain a(an)
a. Disclaimer of opinion.
b. "Except for" qualified opinion.
c. "Subject to" qualified opinion.
d. Unqualified opinion with a separate explanatory paragraph.

M88#60. 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.

M88#61. 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.

M88#62. 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.

M88#63. An auditor may reasonably issue an "except for" qualified opinion for

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<thead>
<tr>
<th>Inadequate disclosure</th>
<th>Scope limitation</th>
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<tr>
<td>a. Yes</td>
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<td>b. Yes</td>
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M88#64. 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>
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<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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M88#65. 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.
Auditing

N88#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.

N88#24. An accountant may accept an engagement to apply agreed-upon procedures that are not sufficient to express an opinion on one or more specified accounts or items of a financial statement provided that
   a. The accountant’s report does not enumerate the procedures performed.
   b. The financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
   c. Distribution of the accountant’s report is restricted.
   d. The accountant is also the entity’s continuing auditor.

N88#25. Reports are considered special reports when issued in connection with
   a. Compliance with aspects of regulatory requirements related to audited financial statements.
   b. Pro forma financial presentations designed to demonstrate the effect of hypothetical transactions.
   c. Feasibility studies presented to illustrate an entity’s results of operations.
   d. Interim financial information reviewed to determine whether material modifications should be made to conform with generally accepted accounting principles.

N88#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.

N88#27. Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a
   a. Partial presentation.
   b. Projected balance sheet.
   c. Financial forecast.
   d. Financial projection.

N88#28. 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.

N88#30. An auditor reporting on comparative financial statements is not required to include an explanatory paragraph in the auditor’s report if the opinion paragraph is modified because of a(an)
   a. Change in accounting principle.
   b. Scope limitation.
   c. Disclaimer of opinion.
   d. Uncertainty affecting the financial statements.

N88#41. An auditor did not observe a client’s taking of beginning physical inventory and was unable to become satisfied about the inventory by means of other auditing procedures. Assuming no other scope limitations or reporting problems, the auditor could issue an unqualified opinion on the current year’s financial statements for
   a. The balance sheet only.
   b. The income statement only.
   c. The income and retained earnings statements only.
   d. All of the financial statements.

N88#42. Which of the following representations does an auditor make explicitly and which implicitly when issuing an unqualified opinion?

<table>
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<tr>
<th>Conformity with GAAP</th>
<th>Adequacy of disclosure</th>
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<td>b. Implicitly</td>
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<td>c. Implicitly</td>
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<tr>
<td>d. Explicitly</td>
<td>Implicitly</td>
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N88#45. An auditor’s report expresses an unqualified opinion and includes a middle paragraph that emphasizes a matter included in the notes to the financial statements. The auditor’s report would be deficient if the middle paragraph states that the entity
   a. Has changed from the completed-contract method to the percentage of completion method of accounting for long-term construction contracts.
b. Has had a significant subsequent event.
c. Has accounting reclassifications that enhance the comparability between the current and prior year.
d. Is a component of a larger business enterprise.

M88#47. For a particular entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, it is not required that the principles selected
a. Be appropriate in the circumstances for the particular entity.
b. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
c. Present information in the financial statements that is classified and summarized in a reasonable manner.
d. Be applied on a basis consistent with those followed in the prior year.

M88#48. Which of the following circumstances requires modification of the accountant's report on a review of interim financial information of a publicly held entity?

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<th>Inadequate disclosure</th>
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<td>b. No</td>
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<td>c. Yes</td>
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<td>d. No</td>
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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#2. When a question arises about an entity's continued existence, the auditor should consider factors tending to mitigate the significance of contrary information concerning the entity's alternative means for maintaining adequate cash flow. An example of such a factor is the
a. Possibility of purchasing certain assets rather than leasing them.
b. Capability of extending the due dates of existing loans.
c. Feasibility of operating at increased levels of production.
d. Marketability of property and equipment that management plans to keep.

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.
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.

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.

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.

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.

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.

An accountant has been asked to issue a review report on the balance sheet of a nonpublic company but not to report on the other basic financial statements. The accountant may not do so
   a. Because compliance with this request would result in an incomplete review.
   b. Because compliance with this request would result in a violation of the ethical standards of the profession.
   c. If the scope of the inquiry and analytical procedures has been restricted.
   d. If the review of the balance sheet discloses material departures from generally accepted accounting principles.

If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express either an
   a. “Except for” qualified opinion or an adverse opinion.
   b. Adverse opinion or a “subject to” qualified opinion.
   c. “Subject to” qualified opinion or an unqualified opinion with a separate explanatory paragraph.
   d. Unqualified opinion with a separate explanatory paragraph or an “except for” qualified opinion.

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.

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.

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.

M90#15. An annual shareholders’ report includes audited financial statements and contains a management report asserting that the financial statements are the responsibility of management. Is it permissible for the auditor’s report to refer to the management report?
   a. Yes, because the reference may lead to the belief that the auditor is providing assurances about management’s representations.
   b. No, because the auditor has no responsibility to read the other information in a document containing audited financial statements.
   c. Yes, provided the reference is included in a separate explanatory paragraph of the auditor’s report.
   d. Yes, provided the auditor reads the management report and discovers no material misrepresentation of fact.

M90#24. When an independent accountant’s report based on a review of interim financial information is presented in a registration statement, a prospectus should include a statement about the accountant’s involvement. This statement should clarify that the accountant is not an “expert” within the meaning of the Securities Act of 1933.
   a. Accountant is not an “expert” within the meaning of the Securities Act of 1933.
   b. Accountant’s review report is not a “part” of the registration statement within the meaning of the Securities Act of 1933.
   c. Accountant performed only limited auditing procedures on the interim financial statements.
   d. Accountant’s review was performed in accordance with standards established by the American Institute of CPAs.

M90#25. If management declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(an)
   a. Adverse opinion.
   b. Qualified opinion with an explanatory paragraph.
   c. Unqualified opinion.
   d. Unqualified opinion with an additional explanatory paragraph.

B. Other Reporting Considerations

M91#54. Comfort letters ordinarily are addressed to
   a. Creditor financial institutions.
   b. The client’s audit committee.
   c. The Securities and Exchange Commission.
   d. Underwriters of securities.


**Auditing**

**N89#1.** When a principal auditor decides to make reference to another auditor's examination, the principal auditor's report should always indicate clearly, in the introductory, scope, and opinion paragraphs, the

a. Magnitude of the portion of the financial statements examined by the other auditor.

b. Disclaimer of responsibility concerning the portion of the financial statements examined by the other auditor.

c. Name of the other auditor.

d. Division of responsibility.

**N89#23.** A former client requests a predecessor auditor to reissue an audit report on a prior period's financial statements. The financial statements are not restated and the report is not revised. What date(s) should the predecessor auditor use in the reissued report?

a. The date of the prior-period report.

b. The date of the client's request.

c. The date of reissue.

d. The dual-dates.

**N89#25.** If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may express an opinion that the accompanying information is fairly stated in

a. Conformity with generally accepted accounting principles.

b. All material respects in relation to the basic financial statements taken as a whole.

c. Conformity with standards established by the AICPA.

d. Accordance with generally accepted auditing standards.

**N88#60.** An auditor may issue the standard audit report when the

a. Auditor refers to the findings of a specialist.

b. Financial statements are derived and condensed from complete audited financial statements that are filed with a regulatory agency.

c. Financial statements are prepared on the cash receipts and disbursements basis of accounting.

d. Principal auditor assumes responsibility for the work of another auditor.

**N88#14.** The Securities and Exchange Commission has authority to

a. Prescribe specific auditing procedures to detect fraud concerning inventories and accounts receivable of companies engaged in interstate commerce.

b. Deny lack of privity as a defense in third-party actions for gross negligence against the auditors of public companies.

c. Determine accounting principles for the purpose of financial reporting by companies offering securities to the public.

d. Require a change of auditors of governmental entities after a given period of years as a means of ensuring auditor independence.

**N88#29.** After an audit report containing an unqualified opinion on a non-public client's financial statements was issued, the client decided to sell the shares of a subsidiary that accounts for 30% of its revenue and 25% of its net income. The auditor should

a. Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.

b. Notify the entity that the auditor's report may no longer be associated with the financial statements.

c. Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.

d. Take no action because the auditor has no obligation to make any further inquiries.

**N88#29.** The principal auditor is satisfied with the independence and professional reputation of the other auditor who has audited the financial statements of a subsidiary. To indicate the division of responsibility, the principal auditor should modify

a. Only the opinion paragraph of the report.

b. Only the opinion paragraph of the report and include an explanatory middle paragraph.

c. Only the scope paragraph of the report.

d. Both the scope and opinion paragraphs of the report.

**N88#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.
Selected Questions

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.

M87#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.

M87#50. 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#58. Subsequent to the issuance of the auditor's report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next

a. Notify the board of directors that the auditor's report must no longer be associated with the financial statements.
b. Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
c. Request that management disclose the effects of the newly discovered information by adding a footnote to subsequently issued financial statements.
d. Issue revised pro forma financial statements taking into consideration the newly discovered information.

M87#59. Which of the following best describes the auditor's reporting responsibility concerning information accompanying the basic financial statements in an auditor-submitted document?

a. The auditor should report on all the information included in the document.
b. The auditor should report on the basic financial statements but may not issue a report covering the accompanying information.
c. The auditor should report on the information accompanying the basic financial statements only if the auditor participated in the preparation of the accompanying information.
d. The auditor should report on the information accompanying the basic financial statements only if the document is being distributed to public shareholders.
## I. Professional Responsibilities

### A. General Standards and Code of Professional Conduct

- **M88#52 a**
- **N88# 6 a**
- **M90#49 a**
- **M88#53 d**
- **N88# 7 d**
- **M90#55 d**
- **N87#17 c**
- **N88#11 b**
- **M90#56 d**
- **N87#18 b**
- **N88#23 b**
- **M90#57 b**
- **M91#52 c**
- **N87#19 a**
- **N88#33 b**
- **M90#58 a**
- **M91#57 b**
- **N87#22 c**
- **M88#54 d**
- **M90#59 d**
- **N90#37 d**
- **M87# 1 c**
- **M88#55 b**
- **N90#59 d**
- **N90#39 d**
- **M87#29 b**
- **M88#56 c**
- **N89#60 a**
- **M90#46 b**
- **N87#23 d**
- **N88# 9 b**
- **M90#47 b**
- **N87#26 d**
- **N88#10 d**
- **M90#60 d**
- **N87#27 a**
- **N88#12 a**
- **N89#49 b**
- **M90#49 b**
- **N87#15 c**
- **N89#56 c**
- **M90#50 b**
- **M89# 2 c**
- **N88# 3 d**
- **N88#30 c**
- **M89# 5 a**
- **M90#51 c**
- **N88#58 a**
- **N89# 3 a**
- **N90#36 a**
- **M87# 10 a**
- **N88# 2 d**
- **M90#52 a**
- **M91#51 b**
- **N87#24 d**
- **N88# 3 a**
- **M90#53 c**
- **M91#56 c**
- **N87#25 c**
- **N88# 4 a**
- **M90#54 b**
- **M91#58 b**
- **N87#28 b**
- **N88# 5 c**
- **M89# 4 c**
- **N90#38 a**
- **M87# 5 c**
- **M88#51 c**
- **M89# 5 d**
- **M90#48 b**
- **M87# 6 b**

### B. Control of the Audit

- **N87#27 a**
- **N87#49 b**
- **N87#30 c**
- **M89# 5 c**
- **M88#51 c**
- **N89#42 a**
- **N89#43 a**
- **C. Other Responsibilities**

- **M88#59 b**
- **N87#10 a**
- **N87#24 d**
- **N87#25 c**
- **N87#28 b**
- **M87# 5 c**
- **M87# 6 b**

## II. Internal Control

### A. Definitions and Basic Concepts

- **M91#21 d**
- **M91#22 b**
- **M91#23 b**
- **N90#41 b**
- **N90#42 d**
- **M90#26 c**
- **M90#27 a**
- **M90#28 a**
- **N89#36 d**
- **N89#37 b**
- **N89#38 a**
- **M89# 6 d**
- **M89# 7 c**
- **N88#31 b**
- **N88#32 b**
- **N88#36 a**
- **N87#42 d**
- **M87# 2 d**

### B. Consideration of the Internal Control Structure

- **N89#42 a**
- **N89#43 a**
- **M91#28 c**
- **M89# 8 d**
- **M89# 9 b**
- **M91#29 c**
- **M91#24 d**
- **M89#10 c**
- **M91#30 c**
- **M89#25 d**
- **M91#31 b**
- **M91#26 a**
- **M91#32 d**
- **M89#12 b**
- **M91#32 d**
- **M89#13 b**
- **M90#48 c**
- **N90#34 a**
- **N90#49 a**
- **N90#50 c**
- **N90#44 d**
- **N90#51 d**
- **N88#38 b**
- **N90#54 d**
- **N88#39 c**
- **N90#52 d**
- **N88#49 b**
- **N90#53 b**
- **M88# 3 c**
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- **M90#34 a**
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- **M88# 7 c**
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- **M89#29 b**
- **M90#37 c**
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- **M90#36 c**
- **N88#45 c**
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- **M90#38 c**
- **N88#39 c**
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- **M90#39 d**
- **M88# 46 a**
- **N90#52 d**
- **M88# 7 c**
- **M90#47 b**
- **N90#39 d**
- **M87#11 d**
- **N89#45 d**
### Auditing

| N89/#46 d | N87/#53 d | M91/#39 b | N89/#55 d |
| N89/#47 d | N87/#54 b | M91/#40 a | N89/#58 b |
| N89/#48 b | N87/#55 a | M91/#47 a | M89/#20 d |
| M89/#14 c | N87/#56 b | N90/#55 b | M89/#21 b |
| M89/#15 a | M87/#12 c | N90/#56 c | M89/#22 a |
| M89/#17 d | M87/#13 b | N90/#57 a | M89/#23 c |
| M89/#18 b | M87/#14 b | N90/#58 a | M89/#24 a |
| M89/#19 c | M87/#15 d | N90/#59 a | M89/#25 b |
| N88/#40 b | M87/#16 a | N90/#60 b | N88/#35 d |
| N88/#41 a | M87/#17 b | M90/#40 d | N88/#47 c |
| N88/#42 a | M87/#20 c | M90/#41 a | N88/#48 c |
| N88/#43 b | M87/#21 d | M90/#42 b | N88/#60 b |
| N88/#44 c | M90/#43 b | M89/#15 d | M88/#24 b |
| N88/#45 d | M90/#44 a | N87/#16 b | N87/#51 c |
| M88/#9 b | M91/#33 a | N89/#50 a | N87/#52 b |
| M88/#10 a | M91/#34 d | N89/#51 d | N87/#57 a |
| M88/#20 b | M91/#35 d | N89/#52 c | M87/#19 c |
| N87/#48 d | M91/#36 b | N89/#53 b | M87/#24 b |
| N87/#50 a | M91/#37 c | N89/#54 d | M87/#25 c |

### III. Evidence and Procedures

#### A. Audit Evidence

| N87/#33 c | N87/#34 b | M91/#26 b | M89/#40 c |
| N87/#3 d | M87/#23 d | M88/#28 b | M89/#42 d |
| M87/#27 c | M87/#28 a | M88/#29 b | M89/#43 d |
| M87/#30 d | M87/#31 b | M88/#39 c | M89/#44 b |
| M87/#32 a | M87/#36 b | N88/#31 a | N88/#57 a |
| M87/#46 c | M87/#38 b | N87/#37 d | N88/#59 b |
| M87/#43 c | M87/#43 c | M88/#17 b | M88/#33 d |

#### B. Specific Audit

| M91/#8 b | M91/#9 a | M91/#14 c | M91/#15 a |
| M91/#10 c | M91/#11 d | M91/#16 c | M91/#17 c |
| M91/#12 a | M91/#13 a | M91/#18 a | M87/#45 a |
| N89/#24 c | N90/#26 c | N90/#28 d | M87/#47 a |
| N90/#27 c | M90/#6 c | N90/#29 d | M87/#48 c |
| M90/#7 a | M90/#8 a | N90/#30 b | M88/#36 d |
| M90/#9 a | M90/#10 b | N90/#31 c | M88/#37 b |
| M90/#11 a | M90/#12 a | N90/#32 c | M88/#38 d |
| N89/#26 c | N90/#26 d | N90/#33 b | M91/#33 a |
| N89/#27 c | N90/#27 c | N90/#34 c | M91/#36 a |
| N89/#30 c | N89/#28 a | N89/#35 c | M91/#39 a |

#### C. Other Specific Audit

| M89/#20 c | M89/#21 c | M90/#28 a | M89/#29 a |
| M90/#22 a | M90/#23 d | M89/#30 c | M89/#32 b |
| M90/#23 d | M90/#1 b | M89/#34 b | M89/#36 c |
| M90/#2 a | M90/#5 a | M89/#39 c | N90/#5 a |
| M90/#2 a | M90/#5 b | M90/#9 a | M90/#10 b |
| M90/#2 a | M90/#11 a | M90/#12 a | M90/#13 a |
| M90/#2 a | M90/#24 c | N90/#28 d | N90/#32 c |
| M90/#2 a | M90/#27 c | N90/#33 b | N90/#34 c |
| M90/#2 a | M90/#30 a | M90/#35 a | M90/#36 a |
| M90/#2 a | M90/#37 a | M90/#38 a | M89/#37 a |
| M90/#2 a | M90/#39 a | N88/#54 b | N88/#55 a |

#### D. Review and Compilation

| M91/#19 a | M91/#20 b | M90/#4 a | N89/#35 c |
| M91/#20 a | M91/#20 b | M90/#4 b | N89/#35 c |
| M91/#20 b | M91/#20 b | M90/#4 a | N89/#35 c |
| M91/#20 b | M91/#20 b | M90/#4 a | N89/#35 c |
### Reporting

#### A. Reporting Standards and Types of Reports

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#### B. Other Reporting Considerations

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Unofficial Answers
ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

M91
Number 5 (Estimated time — — 15 to 25 minutes)

Green, CPA, is considering audit risk at the financial statement level in planning the audit of National Federal Bank (NFB) Company’s financial statements for the year ended December 31, 1990. Audit risk at the financial statement level is influenced by the risk of material misstatements, which may be indicated by a combination of factors related to management, the industry, and the entity. In assessing such factors Green has gathered the following information concerning NFB’s environment.

Company profile:

NFB is a federally-insured bank that has been consistently more profitable than the industry average by marketing mortgages on properties in a prosperous rural area, which has experienced considerable growth in recent years. NFB packages its mortgages and sells them to large mortgage investment trusts. Despite recent volatility of interest rates, NFB has been able to continue selling its mortgages as a source of new lendable funds.

NFB’s board of directors is controlled by Smith, the majority stockholder, who also acts as the chief executive officer. Management at the bank’s branch offices has authority for directing and controlling NFB’s operations and is compensated based on branch profitability. The internal auditor reports directly to Harris, a minority shareholder, who also acts as chairman of the board’s audit committee.

The accounting department has experienced little turnover in personnel during the five years Green has audited NFB. NFB’s formula consistently underestimates the allowance for loan losses, but its controller has always been receptive to Green’s suggestions to increase the allowance during each engagement.

Recent developments:

During 1990, NFB opened a branch office in a suburban town thirty miles from its principal place of business. Although this branch is not yet profitable due to competition from several well-established regional banks, management believes that the branch will be profitable by 1992.

Also, during 1990, NFB increased the efficiency of its accounting operations by installing a new, sophisticated computer system.

Required:

Based only on the information above, describe the factors that most likely would have an effect on the risk of material misstatements. Indicate whether each factor increases or decreases the risk. Use the format illustrated below.

<table>
<thead>
<tr>
<th>Environmental factor</th>
<th>Effect on risk of material misstatements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch management has authority for directing and controlling operations.</td>
<td>Increase</td>
</tr>
</tbody>
</table>

M90
Number 2 (Estimated time — — 15 to 25 minutes)

Dodd, CPA, audited Adams Company’s financial statements for the year ended December 31, 1989. On November 1, 1990, Adams notified Dodd that it was changing auditors and that Dodd’s services were being terminated. On November 5, 1990, Adams invited Hall, CPA, to make a proposal for an engagement to audit its financial statements for the year ended December 31, 1990.

Required:

a. What procedures concerning Dodd should Hall perform before accepting the engagement?

b. What additional procedures should Hall consider performing during the planning phase of this audit (after acceptance of the engagement) that would not be performed during the audit of a continuing client?
The following long-term debt working paper (indexed K-1) was prepared by client personnel and audited by AA, an audit assistant, during the calendar year 1988 audit of American Widgets, Inc., a continuing audit client. The engagement supervisor is reviewing the working papers thoroughly.

**American Widgets, Inc.**  
**WORKING PAPERS**  
**December 31, 1988**

<table>
<thead>
<tr>
<th>Lender</th>
<th>Interest Rate</th>
<th>Payment Terms</th>
<th>Collateral</th>
<th>Balance 12/31/88</th>
<th>1988 Borrowings</th>
<th>1988 Reductions</th>
<th>Balance 12/31/88</th>
<th>Interest Rate</th>
<th>Interest Paid on 12/31/88</th>
<th>Accrued Interest Payable 12/31/88</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Commercial Bank</td>
<td>12%</td>
<td>Interest only on 25th of month, principal due in full 1/1/92; no prepayment penalty</td>
<td>Inventories</td>
<td>$50,000</td>
<td>$300,000 A</td>
<td>$100,000</td>
<td>$250,000 CX</td>
<td>$2,500</td>
<td>NR</td>
<td>Dividend of $80,000 paid 9/2/88 (W/P N-3) violates a provision of the debt agreement, which thereby permits lender to demand immediate payment; lender has refused to waive this violation</td>
<td></td>
</tr>
<tr>
<td>Lender’s Capital Corp.</td>
<td>Prime plus 1%</td>
<td>Interest only on last day of month, principal due in full 3/5/90</td>
<td>2nd Mortgage on Park St. Building</td>
<td>100,000</td>
<td>50,000 A</td>
<td>—</td>
<td>200,000 C</td>
<td>12/31/88</td>
<td>—</td>
<td>Prime rate was 8% to 9% during the year</td>
<td></td>
</tr>
<tr>
<td>Gigantic Building &amp; Loan Assoc.</td>
<td>12%</td>
<td>$5,000 principal plus interest due on 5th of month, due in full 12/31/99</td>
<td>1st Mortgage on Park St. Building</td>
<td>720,000</td>
<td>—</td>
<td>60,000</td>
<td>660,000 C</td>
<td>12/31/88</td>
<td>5,642 R</td>
<td>Reclassification entry for current portion proposed (See RJF-3)</td>
<td></td>
</tr>
<tr>
<td>J. Lott, majority stockholder</td>
<td>9%</td>
<td>Due in full 12/31/91</td>
<td>Unsecured</td>
<td>300,000</td>
<td>—</td>
<td>100,000 N</td>
<td>200,000 C</td>
<td>—</td>
<td>—</td>
<td>Borrowed additional $100,000 from J. Lott on 1/7/89</td>
<td></td>
</tr>
</tbody>
</table>

**Interest costs from long-term debt**

- Interest expense for year: $281,333 T/B
- Average loan balance outstanding: $1,406,667 R

**Five year maturities (for disclosure purposes)**

<table>
<thead>
<tr>
<th>Year end</th>
<th>Interest</th>
<th>Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/89</td>
<td>$60,000</td>
<td>260,000</td>
</tr>
<tr>
<td>12/31/90</td>
<td>260,000</td>
<td>310,000</td>
</tr>
<tr>
<td>12/31/91</td>
<td>310,000</td>
<td>60,000</td>
</tr>
<tr>
<td>12/31/92</td>
<td></td>
<td>360,000</td>
</tr>
<tr>
<td>12/31/93</td>
<td></td>
<td>$1,310,000</td>
</tr>
</tbody>
</table>

**Tickmark Legend**

- F: Readied, foots correctly
- C: Confirmed without exception, W/P K-2
- CX: Confirmed with exception, W/P K-3
- NR: Does not recompute correctly
- A: Agreed to loan agreement, validated bank deposit ticket, and board of directors authorization, W/P W-7
- G: Agreed to canceled checks and lender's monthly statements
- N: Agreed to cash disbursements journal and canceled check dated 12/31/88, clearing 1/8/89
- T/B: Traced to working trial balance
- /: Agreed to 12/31/87 working papers
- F: Agreed interest rate, term, and collateral to copy of note and loan agreement
- O: Agreed to canceled check and board of directors' authorization, W/P W-7

**Overall conclusions**

- Long-term debt, accrued interest payable, and interest expense are correct and complete at 12/31/88

**Required:** Identify the deficiencies in the working paper that the engagement supervisor should discover.
Selected Questions

M89
Number 5 (Estimated time — — 15 to 25 minutes)

Reed, CPA, accepted an engagement to audit the financial statements of Smith Company. Reed’s discussions with Smith’s new management and the predecessor auditor indicated the possibility that Smith’s financial statements may be misstated due to the possible occurrence of errors, irregularities, and illegal acts.

Required:

a. Identify and describe Reed’s responsibilities to detect Smith’s errors and irregularities. Do not identify specific audit procedures.

b. Identify and describe Reed’s responsibilities to report Smith’s errors and irregularities.

c. Describe Reed’s responsibilities to detect Smith’s material illegal acts. Do not identify specific audit procedures.

d. Describe Reed’s additional responsibilities to report on errors, irregularities, and illegal acts if this audit were one to which the requirements of Government Auditing Standards apply.

M88
Number 2 (Estimated time — — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

1. Identify the types of engagements that an accountant may perform under these circumstances.

2. Explain the difference between “general use” of and “limited use” of prospective financial statements.

3. Explain what types of prospective financial statements are appropriate for “general use” and what types are appropriate for “limited use.”

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.
II. Internal Control

B. Consideration of the Internal Control Structure

N90
Number 3 (Estimated time — 15 to 25 minutes)

An auditor is required to obtain a sufficient understanding of each of the elements of an entity's internal control structure to plan the audit of the entity's financial statements and to assess control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Required:

a. Identify the elements of an entity's internal control structure.

b. For what purposes should an auditor's understanding of the internal control structure elements be used in planning an audit?

c. Explain the reasons why an auditor may assess control risk at the maximum level for one or more assertions embodied in an account balance.

d. What must an auditor do to support assessing control risk at less than the maximum level when the auditor has determined that controls have been placed in operation?

C. Cycles

M91
Number 4 (Estimated time — 15 to 25 minutes)

The flowchart on the following page depicts the activities relating to the purchasing, receiving, and accounts payable departments of Model Company, Inc.

Required:

Based only on the flowchart, describe the internal control procedures (strengths) that most likely would provide reasonable assurance that specific internal control objectives for the financial statement assertions regarding purchases and accounts payable will be achieved. Do not describe weaknesses in the internal control structure.
A CPA's audit working papers include the narrative description below of the cash receipts and billing portions of the internal control structure of Parktown Medical Center, Inc. Parktown is a small health care provider that is owned by a publicly held corporation. It employs seven salaried physicians, ten nurses, three support staff in a common laboratory, and three clerical workers. The clerical workers perform such tasks as reception, correspondence, cash receipts, billing, and appointment scheduling and are adequately bonded. They are referred to in the narrative as "office manager," "clerk #1," and "clerk #2."

NARRATIVE

Most patients pay for services by cash or check at the time services are rendered. Credit is not approved by the clerical staff. The physician who is to perform the respective services approves credit based on an interview. When credit is approved, the physician files a memo with the billing clerk (clerk #2) to set up the receivable from data generated by the physician.

The servicing physician prepares a charge slip that is given to clerk #1 for pricing and preparation of the patient's bill. Clerk #1 transmits a copy of the bill to clerk #2 for preparation of the revenue summary and for posting in the accounts receivable subsidiary ledger.

The cash receipts functions are performed by clerk #1, who receives cash and checks directly from patients and gives each patient a prenumbered cash receipt. Clerk #1 opens the mail and immediately stamps all checks "for deposit only" and lists cash and checks for deposit. The cash and checks are deposited daily by the office manager. The list of cash and checks together with the related remittance advices are forwarded by clerk #1 to clerk #2. Clerk #1 also serves as receptionist and performs general correspondence duties.

Clerk #2 prepares and sends monthly statements to patients with unpaid balances. Clerk #2 also prepares the cash receipts journal and is responsible for the accounts receivable subsidiary ledger. No other clerical employee is permitted access to the accounts receivable subsidiary ledger. Uncollectible accounts are written off by clerk #2 only after the physician who performed the respective services believes the account to be uncollectible and communicates the write-off approval to the office manager. The office manager then issues a write-off memo that clerk #2 processes.

The office manager supervises the clerks, issues write-off memos, schedules appointments for the doctors, makes bank deposits, reconciles bank statements, and performs general correspondence duties.

Additional services are performed monthly by a local accountant who posts summaries prepared by the clerks to the general ledger, prepares income statements, and files the appropriate payroll forms and tax returns. The accountant reports directly to the parent corporation.

Required:

Based only on the information in the narrative, describe the reportable conditions and one resulting misstatement that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing function. Do not describe how to correct the reportable conditions and potential misstatements. Use the format illustrated below.

<table>
<thead>
<tr>
<th>Reportable condition</th>
<th>Potential misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is no control to verify that fees are recorded and billed at authorized rates and terms.</td>
<td>Accounts receivable could be overstated and uncollectible accounts understated because of the lack of controls.</td>
</tr>
</tbody>
</table>

Taylor, CPA, has been engaged to audit the financial statements of Johnsons Coat Outlet, Inc., a medium-sized mail-order retail store that sells a wide variety of coats to the public.

Required:

Prepare the "Shipments" segment of Taylor's internal control questionnaire. Each question should elicit either a yes or no response.

Do not prepare questions relating to the cash receipts, sales returns and allowances, billing, inventory control, or other segments.

Use the following format:

| Question | Yes | No |
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.
Auditing

M87
Number 2 (Estimated time — 15 to 25 minutes)

Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

Required:
Prepare the “Purchases” segment of the internal accounting control questionnaire to be used in the evaluation of Star’s internal accounting control system. Each question should elicit either a yes or no response.

Do not prepare the receiving, accounts payable, or treasury segments of the internal accounting control questionnaire.

Do not discuss the internal accounting controls over purchases.

D. Other Considerations

M90
Number 3 (Estimated time — 15 to 25 minutes)

During the course of an audit made in accordance with generally accepted auditing standards, an auditor may become aware of matters relating to the client’s internal control structure that may be of interest to the client’s audit committee or to individuals with an equivalent level of authority and responsibility, such as the board of directors, the board of trustees, or the owner in an owner-managed enterprise.

Required:

a. What are meant by the terms “reportable conditions” and “material weaknesses”?

b. What are an auditor’s responsibilities in identifying and reporting these matters?

M88
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?

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.
Selected Questions

III. Evidence and Procedures

A. Audit Evidence

M90
Number 5 (Estimated time — — 15 to 25 minutes)

Kent, CPA, is engaged in the audit of Davidson Corp.'s financial statements for the year ended December 31, 1989. Kent is about to commence auditing Davidson's employee pension expense, but Kent's preliminary inquiries concerning Davidson's defined benefit pension plan lead Kent to believe that some of the actuarial computations and assumptions are so complex that they are beyond the competence ordinarily required of an auditor. Kent is considering engaging Park, an actuary, to assist with this portion of the audit.

Required:

a. What are the factors Kent should consider in the process of selecting Park?

b. What are the matters that should be understood among Kent, Park, and Davidson's management as to the nature of the work to be performed by Park?

c. May Kent refer to Park in the auditor's report if Kent decides to issue an unqualified opinion? Why?

d. May Kent refer to Park in the auditor's report if Kent decides to issue other than an unqualified opinion as a result of Park's findings? Why?

M91
Number 3 (Estimated time — — 15 to 25 minutes)

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. They range from simple comparisons to the use of complex models involving many relationships and elements of data. They involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditors.

Required:

a. Describe the broad purposes of analytical procedures.

b. Identify the sources of information from which an auditor develops expectations.

c. Describe the factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives.

N88
Number 5 (Estimated time — — 15 to 25 minutes)

The purpose of all auditing procedures is to gather sufficient competent evidence for an auditor to form an opinion regarding the financial statements taken as a whole.

Required:

a. In addition to the example below, identify and describe five means or techniques of gathering audit evidence used to evaluate a client's inventory balance.

<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>

B. Specific Audit Objectives and Procedures

M91
Number 3 (Estimated time — — 15 to 25 minutes)

Taylor, CPA, has been engaged to audit the financial statements of Palmer Co., a continuing audit client. Taylor is about to perform substantive audit procedures on Palmer's goodwill (excess of cost over the fair value of net assets purchased) that was acquired in prior years' business combinations. An industry slowdown has occurred recently and purchased operations have not met profit expectations.

During the planning process, Taylor determined that there is a high risk that material misstatements in the assertions related to goodwill could occur. Taylor obtained an understanding of the internal control structure and assessed control risk at the maximum level for the assertions related to goodwill.

Required:

a. Describe the substantive audit procedures Taylor should consider performing in auditing Palmer's goodwill. Do not discuss Palmer's internal control structure.

b. Describe the two significant assertions that Taylor would be most concerned with relative to Palmer's goodwill. Do not describe more than two.
Required:
Describe the substantive audit procedures Kane should apply to Star's trade accounts payable balances. Do not include procedures that would be applied only in the audit of related party payables, amounts withheld from employees, and accrued expenses such as pensions and interest.

M89
Number 2 (Estimated time — 15 to 25 minutes)

Bell, CPA, was engaged to audit the financial statements of Kent Company, a continuing audit client. Bell is about to audit Kent's payroll transactions. Kent uses an in-house payroll department to compute payroll data, and prepare and distribute payroll checks.

During the planning process, Bell determined that the inherent risk of overstatement of payroll expense is high. In addition, Bell obtained an understanding of the internal control structure and assessed control risk at the maximum level for payroll-related assertions.

Required:
Describe the audit procedures Bell should consider performing in the audit of Kent's payroll transactions to address the risk of overstatement. Do not discuss Kent's internal control structure.

N89
Number 4 (Estimated time — 15 to 25 minutes)

Edwards, CPA, is engaged to audit the financial statements of Matthews Wholesaling for the year ended December 31, 1988. Edwards obtained and documented an understanding of the internal control structure relating to the accounts receivable and assessed control risk relating to accounts receivable at the maximum level. Edwards requested and obtained from Matthews an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 1988, and sent positive confirmation requests to a sample of the customers.

Required:
What additional substantive audit procedures should Edwards consider applying in auditing the accounts receivable?
Selected Questions

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.

M87
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.

M87
Number 3 (Estimated time — — 15 to 25 minutes)

Edwards has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client’s accounts receivable balance. Few, if any, errors of account balance overstatement are expected.

Edwards plans to use the following PPS sampling table:

<table>
<thead>
<tr>
<th>Number of Overstatement Errors</th>
<th>Risk of Incorrect Acceptance</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1%       5%       10%   15%   20%</td>
</tr>
<tr>
<td>1</td>
<td>4.61     3.00     2.31   1.90   1.61</td>
</tr>
<tr>
<td>2</td>
<td>6.64     4.75     3.89   3.38   3.00</td>
</tr>
<tr>
<td>3</td>
<td>8.41     6.30     5.33   4.72   4.28</td>
</tr>
<tr>
<td>4</td>
<td>10.05    7.76     6.69   6.02   5.52</td>
</tr>
</tbody>
</table>

Required:

a. Identify the advantages of using PPS sampling over classical variables sampling.

Note: Requirements b and c are not related.

b. Calculate the sampling interval and the sample size Edwards should use given the following information:

- Tolerable error........................................ $15,000
- Risk of incorrect acceptance .......................... 5%
- Number of errors allowed............................. 0
- Recorded amount of accounts receivable ....... $300,000

Note: Requirements b and c are not related.

c. Calculate the total projected error if the following three errors were discovered in a PPS sample:

<table>
<thead>
<tr>
<th>Recorded Amount</th>
<th>Audit Amount</th>
<th>Sampling Interval</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st error</td>
<td>$ 400</td>
<td>$ 320</td>
</tr>
<tr>
<td>2nd error</td>
<td>500</td>
<td>0</td>
</tr>
<tr>
<td>3rd error</td>
<td>3,000</td>
<td>2,500</td>
</tr>
</tbody>
</table>

IV. Reporting

A. Reporting Standards and Types of Reports

M91
Number 2 (Estimated time — — 15 to 25 minutes)

The auditors’ report below was drafted by a staff accountant of Baker and Baker, CPAs, at the completion of the audit of the comparative financial statements of Ocean Shore Partnership for the years ended December 31, 1990 and 1989. Ocean Shore prepares its financial statements on the income tax basis of accounting. The report was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that an unqualified opinion should be expressed.

Auditor’s Report

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of Ocean Shore Partnership as of December 31, 1990 and 1989, and the related statements of revenue and expenses—income tax basis and changes in partners’ capital accounts—income tax basis for the years then ended.

We conducted our audits in accordance with standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of...
material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used as well as evaluating the overall financial statement presentation.

As described in Note A, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes. Accordingly, these financial statements are not designed for those who do not have access to the Partnership’s tax returns.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of Ocean Shore Partnership as of December 31, 1990 and 1989, and its revenue and expenses and changes in partners’ capital accounts for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Baker and Baker, CPAs
April 3, 1991

Required:
Identify the deficiencies contained in the auditors’ report as drafted by the staff accountant. Group the deficiencies by paragraph, where applicable. Do not redraft the report.

M90
Number 5 (Estimated time — — 15 to 25 minutes)

The following report was drafted on October 25, 1990, by Major, CPA, at the completion of the engagement to compile the financial statements of Ajax Company for the year ended September 30, 1990. Ajax is a nonpublic entity in which Major’s child has a material direct financial interest. Ajax decided to omit substantially all of the disclosures required by generally accepted accounting principles because the financial statements will be for management’s use only. The statement of cash flows was also omitted because management does not believe it to be a useful financial statement.

To the Board of Directors of Ajax Company:

I have compiled the accompanying financial statements of Ajax Company as of September 30, 1990, and for the year then ended. I planned and performed the compilation to obtain limited assurance about whether the financial statements are free of material misstatements.

A compilation is limited to presenting information in the form of financial statements. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. I have not audited the accompanying financial statements and, accordingly, do not express any opinion on them.

Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s financial position, results of operations, and changes in financial position.

I am not independent with respect to Ajax Company. This lack of independence is due to my child’s ownership of a material direct financial interest in Ajax Company.

This report is intended solely for the information and use of the Board of Directors and management of Ajax Company and should not be used for any other purpose.

Major, CPA

Required:
Identify the deficiencies contained in Major’s report on the compiled financial statements. Group the deficiencies by paragraph where applicable. Do not redraft the report.

M90
Number 2 (Estimated time — — 15 to 25 minutes)

For the year ended December 31, 1988, Friday & Co., CPAs (Friday), audited the financial statements of Johnson Company and expressed an unqualified opinion on the balance sheet only. Friday did not observe the taking of the physical inventory as of December 31, 1987, because that date was prior to their appointment as auditors. Friday was unable to satisfy themselves regarding inventory by means of other auditing procedures, so they did not express an opinion on the other basic financial statements that year.

For the year ended December 31, 1989, Friday expressed an unqualified opinion on all the basic financial statements and satisfied themselves as to the consistent application of generally accepted accounting principles. The field work was completed on March 11, 1990; the partner-in-charge reviewed the working papers and signed the auditor’s report on March 18, 1990. The report on the comparative financial statements for 1989 and 1988 was delivered to Johnson on March 21, 1990.

Required:
Prepare Friday’s auditor’s report that was submitted to Johnson’s board of directors on the 1989 and 1988 comparative financial statements.

M89
Number 2 (Estimated time — — 15 to 25 minutes)

The auditors’ report below was drafted by a staff accountant of Turner & Turner, CPAs, at the completion of the audit of the financial statements of Lyon Computers, Inc., for the year ended March 31, 1989. It was submitted to the engagement partner who re-
viewed matters thoroughly and properly concluded that Lyon’s disclosures concerning its ability to continue as a going concern for a reasonable period of time were adequate. Early application of Statement on Auditing Standards No. 59, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern, was chosen by Turner & Turner.

To the Board of Directors of Lyon Computers, Inc.:

We have audited the accompanying balance sheet of Lyon Computers, Inc. as of March 31, 1989, and the other related financial statements for the year then ended. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards that require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are in conformity with generally accepted accounting principles. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. We believe that management’s plans in regards to these matters, which are also described in Note X, will permit the Company to continue as a going concern beyond a reasonable period of time. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly, in all material respects, the financial position of Lyon Computers, Inc., and the results of its operations and its cash flows in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Turner & Turner, CPAs
April 28, 1989

Required:
Identify the deficiencies contained in the auditor’s report as drafted by the staff accountant. Group the deficiencies by paragraph. Do not redraft the report.

M88
Number 4 (Estimated time — 15 to 25 minutes)

The following report on the basic financial statements was drafted by a staff assistant at the completion of the review engagement of GLM Company, a continuing client, for the year ended September 30, 1988. The 1987 basic financial statements for the year ended September 30, 1987, which were also reviewed, contained a departure from generally accepted accounting principles that was properly referred to in the 1987 review report dated October 26, 1987. The 1987 financial statements have been restated.

To the Board of Directors of GLM Company:

We have reviewed the accompanying balance sheets of GLM Company as of September 30, 1988 and 1987, and the related statements of income and retained earnings for the years then ended, in accordance with generally accepted auditing standards. Our review included such tests of the accounting records as we considered necessary in the circumstances.

A review consists principally of inquiries of company personnel. It is substantially less in scope than an audit, but more in scope than a compilation. Accordingly, we express only limited assurance on the accompanying financial statements.

Based on our reviews, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles applied on a consistent basis.

In its 1987 financial statements the company stated its land at appraised values. However, as disclosed in note X, the company has restated its 1987 financial statements to reflect land at cost.

November 2, 1988

Required:
Identify the deficiencies in the draft of the proposed report on the comparative financial statements. Group the deficiencies by paragraph. Do not redraft the report.

M88
Number 2 (Estimated time — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:
b. Describe the contents of the accountant’s standard report on a compilation of a financial projection.

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.
SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

**M91**

**Answer 5** (10 points)

The factors most likely to have an effect on the risk of material misstatements and their resulting effect include the following:

<table>
<thead>
<tr>
<th>Environmental factor</th>
<th>Effect on risk of material misstatements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government regulation over the banking industry is extensive.</td>
<td>Decrease</td>
</tr>
<tr>
<td>NFB operates profitably in a growing prosperous area.</td>
<td>Decrease</td>
</tr>
<tr>
<td>Overall demand for the industry's product is high.</td>
<td>Decrease</td>
</tr>
<tr>
<td>Interest rates have been volatile recently.</td>
<td>Increase</td>
</tr>
<tr>
<td>The availability of funds for additional mortgages is promising.</td>
<td>Decrease</td>
</tr>
<tr>
<td>The principal shareholder is also the chief executive officer and controls the board of directors.</td>
<td>Increase</td>
</tr>
<tr>
<td>Branch management is compensated based on branch profitability.</td>
<td>Increase</td>
</tr>
<tr>
<td>The internal auditor reports directly to the chairman of the board's audit committee, a minority shareholder.</td>
<td>Decrease</td>
</tr>
<tr>
<td>The accounting department has experienced little turnover in personnel recently.</td>
<td>Decrease</td>
</tr>
<tr>
<td>NFB is a continuing audit client.</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

Management fails to establish proper procedures to provide reasonable assurance of reliable accounting estimates. | Increase |

Management has been receptive to Green's suggestions relating to accounting adjustments. | Decrease |

NFB recently opened a new branch office that is not yet profitable. | Increase |

NFB recently installed a new sophisticated computer system. | Increase |

**M90**

**Answer 2** (10 points)

a. The procedures Hall should perform before accepting the engagement include the following:

1. Hall should explain to Adams the need to make an inquiry of Dodd and should request permission to do so.

2. Hall should ask Adams to authorize Dodd to respond fully to Hall's inquiries.

3. If Adams refuses to permit Dodd to respond or limits Dodd's response, Hall should inquire as to the reasons and consider the implications in deciding whether to accept the engagement.

4. Hall should make specific and reasonable inquiries of Dodd regarding matters Hall believes will assist in determining whether to accept the engagement, including specific questions regarding

   - Facts that might bear on the integrity of management;
   - Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters;
Auditing

5. If Hall receives a limited response, Hall should consider its implications in deciding whether to accept the engagement.

b. The additional procedures Hall should consider performing during the planning phase of this audit that would not be performed during the audit of a continuing client may include the following:

1. Hall may apply appropriate auditing procedures to the account balances at the beginning of the audit period and, possibly, to transactions in prior periods.

2. Hall may make specific inquiries of Dodd regarding matters Hall believes may affect the conduct of the audit, such as:
   - Audit areas that have required an inordinate amount of time;
   - Audit problems that arose from the condition of the accounting system and records.

3. Hall may request Adams to authorize Dodd to allow a review of Dodd's working papers.


5. Hall should start obtaining the documentation needed to create a permanent working paper file.

M89

Answer 4 (10 points)

The working paper contains the following deficiencies:

1. The subject matter of the working paper is not properly indicated in the title.
2. There is no indication of any follow-up on the identified error in the accrued interest payable computation.
3. There is no indication whether the confirmation exception was resolved.
4. The loan with the waived violation of a provision of the debt agreement is misclassified as long-term.
5. The liability activities of Lender's Capital Corp. and the working paper totals do not crossfoot.
6. There is no indication of cross-referencing of the stockholder loan to the related party transactions working papers.
7. There is no investigation of the payment on the stockholder loan that was reborrowed soon after year-end.
8. There is no consideration of the need to impute interest expense on the 0% stockholder loan.
9. There is no indication that the dates under "interest paid to" were audited.
10. There is no indication that the unusually high average interest rate ($281,333/$1,406,667 = 20%) was noted and investigated.
11. The working paper does not support the overall conclusions expressed.
12. The tickmark "R" is used but not explained in the tickmark legend.
13. There is no indication that the working paper was prepared by client personnel.

M89

Answer 5 (10 points)

a. To satisfy an auditor’s responsibilities to detect Smith’s errors and irregularities, Reed should:

   - Assess the risk that Smith’s errors and irregularities may cause its financial statements to contain a material misstatement.
   - Design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.
   - Exercise due care in planning, performing, and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

b. To satisfy an auditor’s responsibilities to report Smith’s errors and irregularities, Reed should:

   - Inform Smith’s audit committee, or others having equivalent authority and responsibility, about material irregularities of which Reed becomes aware.
   - Express a qualified or an adverse opinion on the financial statements if they are materially affected by an error or irregularity and are not revised.
   - Disclaim or qualify an opinion on the financial statements and communicate the findings to the audit committee or the board of directors if the scope of the audit has been restricted concerning a possible irregularity.
   - Consider notification of outside parties concerning irregularities in certain circumstances.

c. Reed’s responsibilities to detect Smith’s illegal acts that have a material and direct effect on Smith’s financial statements are the same as that for errors and irregularities.

Reed’s responsibilities to detect Smith’s illegal acts that have a material and indirect effect on the financial statements are to be aware of the possibility that such illegal acts may have occurred. If specific information comes to Reed’s attention that provides evidence concerning the existence of such possible illegal acts, Reed should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

d. In an audit to which GAO standards apply, Reed should additionally
Unofficial Answers

- Determine that instances or apparent indications of illegal acts are reported to the funding agency or other specified agency.
- Express positive assurance on whether the items tested were in compliance with applicable laws and regulations.
- Express negative assurance that, except as otherwise noted, nothing came to Reed's attention that caused Reed to believe that the untested items were not in compliance with applicable laws and regulations.

M88
Answer 2

a. 1. An accountant who reports on or assembles prospective financial statements for use by third parties should perform any one of three engagements. The accountant may compile, examine, or apply agreed-upon procedures to the prospective financial statements.
   2. "General use" of prospective financial statements refers to use of the statements by persons (creditors, stockholders, etc.) with whom the responsible party (management) is not negotiating directly. "Limited use" of prospective financial statements refers to the use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly.
   3. Only a financial forecast is appropriate for general use, but any type of prospective financial statements (either a financial forecast or a financial projection) would normally be appropriate for limited use.

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.

II. Internal Control

M90
Answer 3 (10 points)

a. For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:
   - The control environment
   - The accounting system
   - Control procedures

b. In planning an audit, the knowledge obtained from an auditor's understanding of the elements of an entity's internal control structure should be used to:
   - Identify types of potential misstatements.
   - Consider factors that affect the risk of material misstatement.
   - Design substantive tests.

c. An auditor may assess control risk at the maximum level for some or all assertions because the auditor believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

d. To support assessing control risk at less than the maximum level, an auditor must determine whether the policies and procedures are suitably designed to prevent or detect material misstatements in specific financial statement assertions and obtain evidence that the policies and procedures are operating effectively.

C. Cycles

M91
Answer 4 (10 points)

The internal control procedures that most likely would provide reasonable assurance that specific control objectives for the financial statement assertions re-
garding purchases and accounts payable will be achieved are

1. Proper authorization of requisitions by department head is required before purchase orders are prepared.
2. Purchasing department assures that requisitions are within budget limits before purchase orders are prepared.
3. The adequacy of each vendor's past record as a supplier is verified.
4. Secure facilities limit access to the goods during the receiving activity.
5. Receiving department makes a blind count of the goods received, independently of any other department.
6. The requisitioning department head independently verifies the quantity and quality of the goods received.
7. Requisitions, purchase orders, and receiving reports are matched with vendor invoices as to quantity and price.
8. Accounts payable department recomputes the mathematical accuracy of each invoice.
9. The voucher register is independently reconciled to the control accounts monthly.
10. All supporting documentation is required for payment and is made available to the treasurer.
11. The purchasing, receiving, and accounts payable functions are segregated.

**Auditing**

**N99**

**Answer 5 (10 points)**

The reportable conditions and resulting misstatements, in addition to the example, that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing functions include the following:

<table>
<thead>
<tr>
<th>Reportable condition</th>
<th>Potential misstatement</th>
</tr>
</thead>
<tbody>
<tr>
<td>The employees who perform services also are permitted to approve credit without an external credit check.</td>
<td>Uncollectible accounts expense could be understated and accounts receivable could be overstated because of the lack of an appropriate credit check.</td>
</tr>
</tbody>
</table>
| There is no independent verification of the billing process.                        | Fees earned and accounts receivable may be understated because not all services performed might be reported for billing.  
  or                                                                                 | Fees earned and accounts receivable may be either overstated or understated because of the use of incorrect price or service data or because of mathematical errors. |
| The employees who approve credit also approve write-offs of uncollectible accounts.  | Accounts receivable could be understated and uncollectible accounts expense overstated because write-offs of accounts receivable could be approved for accounts that are, in fact, collectible.  
  or                                                                                 | Accounts receivable could be overstated and uncollectible accounts expense understated because write-offs of accounts receivable might not be initiated for accounts that are uncollectible. |
| Credit is not granted on the basis of established limits.                           | Uncollectible accounts expense could be either understated or overstated because the lack of established credit limits may make it more difficult to identify uncollectible amounts. |
| The employee who initially handles cash receipts also prepares billings.             | Fees earned and cash receipts or accounts receivable could be understated because of omitted or inaccurate billing. |
Unofficial Answers

Reportable condition

The employee who makes bank deposits also reconciles bank statements.

Uncollectible accounts are not determined on the basis of established criteria.

Trial balances of the accounts receivable subsidiary ledger are not prepared independently of, or verified and reconciled to, the accounts receivable control account in the general ledger.

Potential misstatement

The cash balance per books may be overstated because not all cash is deposited.

Uncollectible accounts expense could be either understated or overstated because of the lack of established write-off criteria.

Any of fees earned, cash receipts, and uncollectible accounts expense could be either understated or overstated because of undetected differences between the subsidiary ledger and the general ledger.

Fees earned and cash receipts or accounts receivable could be understated because of failure to record billings, cash receipts, or write-offs accurately.

M89
Answer 3 (10 points)

JOHNSONS COAT OUTLET, INC.
Shipments
Internal Control Questionnaire

1. Are shipping documents prepared from sales orders approved in accordance with management's authorization?

2. Are shipping documents pre-numbered?

3. Are shipping documents periodically accounted for?

4. Are shipping documents recorded in a register, log, or file?

5. Are copies of shipping documents forwarded to the Billing department? Inventory control department?

6. Do shipping documents include cross reference to sales orders; customer identity and address; description and quantities of goods shipped; date; and other details?


8. Is access to merchandise restricted and controlled within the shipping department?

Question

Yes

No

9. Are type and quantities of goods withdrawn and packed for shipping verified by independent counts?

10. Are receipts from carriers obtained and filed?

M88
Answer 4 (10 points)

The weaknesses in Newton Hardware's internal accounting controls include these:

Warehouse Clerk

- Initiates posting to inventory records by preparation of shipping advice.
- Releases merchandise to customers before proper approvals of customers' credit.
- Does not retain a copy of the shipping advice for comparison with receipt from carrier.

Bookkeeper A

- Authorizes customers' credit and prepares source documents for posting to customers' accounts.
- Prepares invoices without notice that the merchandise was actually shipped and the date it was shipped.
- Authorizes write-offs of customer accounts receivable and authorizes customers' credit.

Collection Clerk

- Receives directly and records customers' checks.
- Does not deliver checks excluded from the deposit to an employee independent of the bank deposit for review and disposition.
- Initiates posting of receipts to subsidiary accounts receivable ledger and has initial access to cash receipts.
Auditing

- Does not deposit cash receipts promptly.
- Reconciles bank statement and has initial access to cash receipts.

**N87**
**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></td>
<td></td>
</tr>
<tr>
<td>2. Are purchase requisitions approved in accordance with management's authorization?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Are purchases made from approved vendors?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Are price quotations requested for purchases over an established amount?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Are purchase commitments documented on written purchase order forms?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Do purchase orders include adequate descriptions, terms, and instructions?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Are purchase orders approved by authorized personnel before issuance?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Are prenumbered purchase order forms periodically accounted for?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Is a detailed listing of purchase orders maintained?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Is the purchasing function independent of receiving, shipping, invoice processing, and treasury functions?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Are there adequate safeguards over unissued purchase order forms?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Are old items in the open purchase order file periodically investigated?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Are vendors notified of conflict of interest policies?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**D. Other Considerations**

**M90**
**Answer 3** (10 points)

**a.** Reportable conditions are matters that come to an auditor's attention, which, in the auditor's judgment, should be communicated to the client's audit committee or its equivalent because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of specific internal control structure elements do not reduce, to a relatively low level, the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

**b.** An auditor is required to identify reportable conditions that come to the auditor's attention in the normal course of an audit, but is not obligated to search for reportable conditions. The auditor uses judgment as to which matters are reportable conditions. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide certain matters do not need to be reported unless, because of changes in management or the audit committee, or because of the passage of time, it is appropriate to do so.

Conditions noted by the auditor that are considered reportable should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication. The report should state that the communication is intended solely for the information and use of the audit committee, management, and others within the organization.

The auditor may identify and communicate separately those reportable conditions the auditor considers to be material weaknesses, but may not state that no reportable conditions were noted during the audit. Reportable conditions may be communicated during the course of the audit rather than after the audit is concluded, depending on the relative significance of the matters noted and the urgency of corrective follow-up action.

**N88**
**Answer 3** (10 points)

**a.** 1. In determining an acceptable level of risk of overreliance, an auditor should consider the importance of the control to be tested in determining the extent to which substantive tests will be restricted and the planned degree of reliance on that control.

2. In determining the tolerable deviation rate, an auditor should consider the planned degree of reliance on the control to be tested and how materially the financial statements would be affected if the control does not function properly. For example, how likely is the control to prevent or detect material errors?

3. In determining the expected population deviation rate, an auditor should consider the results of prior years' tests, the overall control environment, or utilize a preliminary sample.
b. 1. There is a decrease in sample size if the acceptable level of risk of overreliance is increased.

2. There is a decrease in sample size if the tolerable deviation rate is increased.

3. There is an increase in sample size if the population deviation rate is increased.

c. For a low risk of overreliance it is generally appropriate to reconsider the planned reliance as the calculated estimate of the population deviation rate identified in the sample (7%) approaches the tolerable deviation rate (8%). This is because there may be an unacceptably high sampling risk that these sample results could have occurred with an actual population deviation rate higher than the tolerable deviation rate.

d. If statistical sampling is used, an allowance for sampling risk can be calculated. If the calculated estimate of the population deviation rate plus the allowance for sampling risk is greater than the tolerable deviation rate, the sample results should be interpreted as not supporting the planned reliance on the control.

M87
Answer 4 (10 points)

a. 1. An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting control made as part of an examination of financial statements in accordance with generally accepted auditing standards generally differ in scope. While the engagement to express an opinion on an entity's system can be made in conjunction with the study and evaluation made as part of an examination, the study and evaluation made as part of an examination is more limited in scope.

2. The engagements also differ in purpose. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for reliance on the control system and for determining the nature, extent, and timing of the auditing procedures. The purpose of the accountant's engagement to express an opinion on the system of internal accounting control is to provide assurance about whether the broad objectives of internal accounting control are being achieved.

3. An engagement to express an opinion on an entity's system of internal accounting control can be made as of any date, while the auditor's study and evaluation of internal accounting control is made in the early stages of an audit with review to determine the effectiveness throughout the period.

4. Ordinarily, the users of an opinion on an entity's system of internal accounting control are the client's management or third parties, such as regulatory agencies. The primary user of a study and evaluation of internal accounting control made as part of an audit is the auditor who makes the study and evaluation.

b. The accountant's report expressing an opinion on an entity's system of internal accounting control should contain

a. A description of the scope of the engagement.
b. The date to which the opinion relates.
c. A statement that the establishment and maintenance of the system is the responsibility of management.
d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.
e. The accountant's opinion on whether the system meets the broad objectives of internal accounting control insofar as those objectives pertain to the prevention or detection of material errors or irregularities.
f. The description of any material weakness.

III. Evidence and Procedures

A. Audit Evidence

M90
Answer 5 (10 points)

a. The factors Kent should consider in the process of selecting Park include

- Park's professional certification, license, or other recognition of Park's competence.
- Park's reputation and standing in the views of Park's peers and others familiar with Park's capability or performance.
- Park's relationship, if any, to Davidson Corporation.

b. The understanding among Kent, Park, and Davidson's management as to the nature of the work to be performed by Park should cover

- The objectives and scope of Park's work.
- Park's representations as to Park's relationship, if any to Davidson.
- The methods or assumptions to be used.
- A comparison of the methods or assumptions to be used with those used in the preceding period.
- Park's understanding of Kent's corroborative use of Park's findings.
- The form and content of Park's report that would enable Kent to evaluate Park's findings.
c. Kent may not refer to Park in the auditor's report if Kent decides to issue an unqualified opinion. Such a reference might be misunderstood to be a qualification, a division of responsibility, or an inference that a more thorough audit was performed.

d. Kent may refer to Park in the auditor's report if Kent decides to issue other than an unqualified opinion as a result of Park's findings. Reference is permitted if it will facilitate an understanding of the reason for the modification.

N88
Answer 3 (10 points)

a. Analytical procedures are used for these broad purposes:

- To assist the auditor in planning the nature, timing, and extent of other auditing procedures.
- As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- As an overall review of the financial information in the final review stage of the audit.

b. An auditor's expectations are developed from the following sources of information:

- Financial information for comparable prior periods giving consideration to known changes.
- Anticipated results — for example, budgets, forecasts, and extrapolations.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the client operates.
- Relationships of financial information with relevant nonfinancial information.

c. The factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives are whether the

- Data were obtained from independent sources outside the entity or from sources within the entity.
- Sources within the entity were independent of those who are responsible for the amount being audited.
- Data were developed under a reliable system with adequate controls.
- Data were subjected to audit testing in the current or prior year.
- Expectations were developed using data from a variety of sources.

N88
Answer 5 (10 points)

a. The means or techniques of gathering audit evidence, in addition to the example, are as follows:

<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>
Unofficial Answers

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. |
| 3. Rights and Obligations | • Observe physical inventory counts.  
• Obtain confirmation of inventories at locations outside the entity.  
• Examine paid vendors' invoices, consignment agreements, and contracts.  
• Test shipping and receiving cutoff procedures. |
| 4. Valuation or Allocation | • Examine paid vendors' invoices.  
• Review direct labor rates.  
• Test the computation of standard overhead rates.  
• Examine analyses of purchasing and manufacturing standard cost variances.  
• Examine an analysis of inventory turnover.  
• Review industry experience and trends.  
• Analytically review the relationship of inventory balances to anticipated sales volume.  
• Tour the plant.  
• Inquire of production and sales personnel concerning possible excess or obsolete inventory items.  
• Obtain current market value quotations.  
• Review current production costs.  
• Examine sales after year-end and open purchase order commitments. |
| 5. Presentation and Disclosure | • Review drafts of the financial statements.  
• Compare the disclosures made in the financial statements to the requirements of generally accepted accounting principles.  
• Obtain confirmation of inventories pledged under loan agreements. |
B. Specific Audit Objectives and Procedures

M91
Answer 3 (10 points)

a. Taylor should consider performing the following procedures in the audit of Palmer’s goodwill:

- Trace the totals in the account analysis for each significant acquisition to the general ledger;
- Trace the opening balance to the audit working papers for the preceding year;
- Examine supporting documents for evidence of continued ownership of the acquisitions that resulted in excess of costs over fair value of net assets;
- Review the reasonableness and consistency of application of the method of amortization used;
- Determine that the amortization period is reasonable;
- Recompute amortization;
- Determine that the carrying amount does not exceed amounts properly allocable to future periods;
- Assess whether there has been a permanent impairment of value;
- Trace amounts amortized during the period to the related general ledger expense accounts;
- Examine evidence supporting additions and reductions during the year (e.g., contingency payments properly capitalizable, reductions due to recovery of preacquisition taxes, etc.);
- Ascertain whether goodwill and amortization are properly described and classified in the financial statements and disclosed in the notes to the financial statements.

b. The two significant assertions that Taylor would be most concerned with relative to Palmer’s goodwill are valuation or allocation, and presentation and disclosure. Taylor would be most concerned with the risk of the loss of recoverability of the goodwill’s market value due to not meeting profit expectations, and the risk of inadequate disclosure or presentation in the financial statements.

M90
Answer 4 (10 points)

The substantive audit procedures Kane should apply to Star’s trade accounts payable balances include the following:

- Foot the schedule of the trade accounts payable.
- Agree the total of the schedule to the general ledger trial balance.
- Compare a sample of individual account balances from the schedule with the accounts payable subsidiary ledger.
- Compare a sample of individual account balances from the accounts payable subsidiary ledger with the schedule.

- Investigate and discuss with management any old or disputed payables.
- Investigate debit balances and, if significant, consider requesting positive confirmations and propose reclassification of the amounts.
- Review the minutes of board of directors’ meetings and any written agreements and inquire of key employees as to whether any assets are pledged to collateralize payables.
- Performing cut-off tests.
- Performing analytical procedures.

Confirm or verify recorded accounts payable balances by:

- Reviewing the voucher register or subsidiary accounts payable ledger and consider confirming payables of a sample of vendors.
- Requesting a sample of vendors to provide statements of account balances as of the date selected.
- Investigating and reconciling differences discovered during the confirmation procedures.
- Testing a sample of unconfirmed balances by examining the related vouchers, invoices, purchase orders, and receiving reports.

Perform a search for unrecorded liabilities by:

- Examining files of receiving reports unmatched with vendors’ invoices, searching for items received before the balance sheet date but not yet billed or on the schedule.
- Inspecting files of unprocessed invoices, purchase orders, and vendors’ statements.
- Reviewing support for the cash disbursements journal, the voucher register, or canceled checks for disbursements after the balance sheet date to identify transactions that should have been recorded at the balance sheet date, but were not.
- Inquiring of key employees about additional sources of unprocessed invoices or other trade payables.

M99
Answer 2 (10 points)

Bell should consider performing the following procedures in the audit of Kent’s payroll transactions:

Select a sample of payments to employees from the payroll register and compare each selected transaction to the related documents and records examining

- Evidence in support of authorization of rate of pay.
- Evidence in support of time on which compensation was based, such as approved time cards or attendance records.
- Evidence in support of proper authorization of payroll withholdings.
- Evidence in support of payment, such as canceled payroll checks.
- Evidence in support of account distribution.
Unofficial Answers

- The clerical accuracy of the transaction.
- The entry to the employee's records used to summarize employee compensation for payroll reporting purposes.

Obtain the payroll register for a selected period and

- Test the arithmetical accuracy of the payroll register.
- Determine whether payroll was approved in accordance with management's prescribed procedures.
- Trace totals per the register to postings in the general ledger.

Observe the distribution of payroll checks.
Review the accounting for unclaimed wages.
Observe a sample of employees in the performance of their duties.
Perform analytical procedures.

M89
Answer 4 (10 points)

Edwards should consider applying the following additional substantive audit procedures:

- Test the accuracy of the aged accounts receivable schedule.
- Send second requests for all unanswered positive confirmation requests.
- Perform alternative auditing procedures for unanswered second confirmation requests.
- Reconcile and investigate exceptions reported on the confirmations.
- Project the results of the sample confirmation procedures to the population and evaluate the confirmation results.
- Determine whether any accounts receivable are owed by employees or related parties.
- Test the cut-off of sales, cash receipts, and sales returns and allowances.
- Evaluate the reasonableness of the allowance for doubtful accounts.
- Perform analytical procedures for accounts receivable (e.g., accounts receivable to credit sales, allowance for doubtful accounts to accounts receivable, sales to returns and allowances, doubtful accounts expense to net credit sales).
- Identify differences, if any, between the book and tax basis for the allowance for doubtful accounts and related expense.
- Review activity after the balance sheet date for unusual transactions.
- Determine that the presentation and disclosure of accounts receivable is in conformity with generally accepted accounting principles consistently applied.

M88
Answer 3 (10 points)

The substantive audit procedures that Young should apply when testing for loss contingencies relating to litigation, claims, and assessments include the following:

- Read minutes of meetings of stockholders, directors, and committees.
- Read contracts, loan agreements, leases, and other documents.
- Read correspondence with taxing and other governmental agencies.
- Read correspondence with insurance and bonding companies.
- Read confirmation replies for information concerning guarantees.
- Discuss with management the entity's policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management or inside general counsel a description and evaluation of litigation, claims, and assessments.
- Obtain written assurance from management that the financial statements include all accruals and disclosures required by Statement on Financial Accounting Standards No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence from lawyers.
- Obtain an analysis of professional fee expenses and review supporting invoices for indications of contingencies.
- Request the client's management to prepare for transmittal a letter of inquiry to those lawyers consulted by the client concerning litigation, claims, and assessments.
- Compare the lawyer's response to the items in the letter of inquiry to the description and evaluation of litigation, claims, and assessments obtained from management.
- Determine that the financial statements include proper accruals and disclosures of the contingencies.

N87
Answer 3 (10 points)

The auditor should

- Review answers to questions on confirmation requests to determine proper recognition in accounting records and the necessity for financial statement disclosure.
- Make inquiries as to compensating balances and restrictions.
- Obtain copies of the bank reconciliations as of the balance sheet date, and
- Trace the adjusted book balances to the general ledger balances.
• Compare the bank balances to the opening balances on the cut-off bank statements.
• Compare the bank balances to the balances on the confirmations.
• Trace amounts of deposits in transit to the cut-off bank statements and ascertain whether the time lags are reasonable.
• Verify the clerical accuracy of the reconciliations.
• Obtain explanation for unusual reconciling items, including checks drawn to "bearer," "cash," and related parties.
• Trace checks dated prior to the end of the period that were returned with the cut-off statements to the list of outstanding checks.
• Investigate outstanding checks that did not clear with the cut-off bank statements.
• Examine a sample of checks for payee, amount, date, authorized signatures, and endorsements to determine any irregularities from company policy or accounting records.

• Prepare a bank transfer schedule from a review of the cash receipts and disbursements journals, bank statements, and related paid checks for the last few days before and the first few days after the year-end, and

• Review the schedule to determine that the deposit and disbursement of each transfer is recorded in the proper period.
• Trace incomplete transfers to the schedule of outstanding checks and deposits in transit.

C. Other Specific Audit Topics

M90
Answer 4 (10 points)

a. The first type of subsequent events includes those events that provide additional evidence concerning conditions that existed at the balance sheet date and affect the estimates inherent in the process of preparing financial statements. This type of subsequent events requires that the financial statements be adjusted for any changes in estimates resulting from the use of such additional evidence.

The second type of subsequent events consists of those events that provide evidence concerning conditions that did not exist at the balance sheet date but arose subsequent to that date. These events should not result in adjustment to the financial statements but may be such that disclosure is required to keep the financial statements from being misleading.

b. The auditing procedures Green should consider performing to gather evidence concerning subsequent events include the following:

• Compare the latest available interim statements with the financial statements being audited.
• Ascertain whether the interim statements were prepared on the same basis as the audited financial statements.
• Inquire whether any contingent liabilities or commitments existed at the balance sheet date or the date of inquiry.
• Inquire whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.
• Inquire about the current status of items in the audited financial statements that were accounted for on the basis of tentative, preliminary, or inconclusive data.
• Inquire about any unusual adjustments made since the balance sheet date.
• Read or inquire about the minutes of meetings of stockholders or the board of directors.
• Inquire of the client's legal counsel concerning litigation, claims, and assessments.
• Obtain a management representation letter, dated as of the date of Green's report, as to whether any subsequent events would require adjustment or disclosure.
• Make such additional inquiries or perform such additional procedures Green considers necessary and appropriate.

N88
Answer 2 (10 points)

The audit procedures Temple should apply to identify Ford's related party relationships and transactions include the following:

• Evaluate the company's procedures for identifying and properly reporting related party relationships and transactions.
• Request from management the names of all related parties and inquire whether there were any transactions with these parties during the period.
• Review tax returns and filings with other regulatory agencies for the names of related parties.
• Determine the names of all pension plans and other trusts and the names of their officers and trustees.
• Review stock certificate book to identify the stockholders.
• Review material investment transactions to determine whether the investments created related party relationships.
• Review the minutes of board of directors' meetings.
• Review conflict-of-interest statements obtained by the company from its management.
• Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders.
• Consider whether transactions are occurring, but are not being given proper accounting recognition, e.g., personal use of company vehicles, interest-free loans, etc.
• Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
• Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
• Review invoices from law firms that have performed services for the company for indications of the existence of related party relationships or transactions.
• Review confirmations of loans receivable and payable for indications of guarantees, and determine their nature and the relationships, if any, of the guarantors to the reporting entity.

M87

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.

M87

Answer 3 (10 points)

a. The advantages of PPS sampling over classical variables sampling are as follows:

• PPS sampling is generally easier to use than classical variables sampling.
• Size of a PPS sample is not based on the estimated variation of audited amounts.
• PPS sampling automatically results in a stratified sample.
• Individually significant items are automatically identified.
• If no errors are expected, PPS sampling will usually result in a smaller sample size than classical variables sampling.
• A PPS sample can be easily designed and sample selection can begin before the complete population is available.

b. The formula for determining the sampling interval is:

\[
\text{Sampling Interval} = \frac{\text{Tolerable Error}}{\text{Reliability Factor for Errors of Overstatement}}
\]

\[
= \frac{\$15,000}{3.00} = \$5,000
\]

(continued)
Auditing

Sample Size = Recorded Amount
Sampling Interval

= $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>
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</thead>
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<td>1st error</td>
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<tr>
<td>2nd error</td>
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<td>1,000</td>
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<tr>
<td>3rd error</td>
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<td>2,500</td>
<td>*</td>
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<tr>
<td>Total Projected Error</td>
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<td></td>
<td>$1,700</td>
</tr>
</tbody>
</table>

* The recorded amount is greater than the sampling interval; therefore, the projected error equals the actual error.

IV. Reporting

A. Reporting Standards and Types of Reports

The auditors' report contains the following deficiencies:

1. “Independent” is omitted from the title of the auditors' report.

Introduction paragraph

2. Management’s responsibility for the financial statements is omitted.

3. The auditors’ responsibility to express an opinion on the financial statements is omitted.

Scope paragraph

4. “Generally accepted auditing standards” should be referred to, not standards established by the AICPA.

5. Reference to assessing “significant estimates made by management” is omitted.

6. The concluding statement that the auditors “believe that our audits provide a reasonable basis for our opinion” is omitted.

Explanatory paragraph

7. Reference to the income tax basis of accounting as “a comprehensive basis of accounting other than generally accepted accounting principles” is omitted.

8. The statement that the financial statements are “not designed for those who do not have access to the Partnership tax returns” is inappropriate.

Opinion paragraph

9. The income tax basis of accounting “described in Note A” should be referred to, not “generally accepted accounting principles.”

10. There should be no reference to consistency unless the accounting principles have not been applied consistently.

N90

Answer 5 (10 points)

Deficiencies in the report on the compiled financial statements are as follows:

Within the first paragraph

- The financial statements are not properly identified.
- Standards established by the AICPA should be referred to.
- The expression “to obtain limited assurance” should not be used.
Within the second paragraph

- The information is not stated to be the representation of management.
- The phrase “less in scope than an audit” is inappropriate.
- Reference to the financial statements not being reviewed is omitted.
- Reference to “any other form of assurance” is omitted.

Within the third paragraph

- Reference to the omission of the statement of cash flows is omitted.
- There should be a statement that the financial statements are not designed for those uninformed about the omitted disclosures.
- It is inappropriate to refer to changes in financial position.

Within the fourth paragraph

- The reason for the accountant’s lack of independence should not be described.

Inclusion of the fifth paragraph is inappropriate.

The accountant’s compilation report is not dated October 25, 1990.

**M89**

**Answer 2 (10 points)**

**Independent Auditor’s Report**

To the Board of Directors of Johnson Company:

We have audited the accompanying balance sheets of Johnson Company as of December 31, 1989 and 1988, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 1987, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 1987, enter into the determination of net income and cash flows for the year ended December 31, 1988.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and do not express, an opinion on the results of operations and cash flows for the year ended December 31, 1988.

In our opinion, the balance sheets of Johnson Company as of December 31, 1989 and 1988, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 1989 present fairly, in all material respects, the financial position of Johnson Company as of December 31, 1989 and 1988, and the results of its operations and its cash flows for the year ended December 31, 1989, in conformity with generally accepted accounting principles.

Friday & Co., CPAs
March 11, 1990

**M89**

**Answer 2 (10 points)**

The auditor’s report contains the following deficiencies:

**Opening (Introductory) paragraph**

1. All the financial statements audited are not identified.

2. Management’s responsibility for the financial statements is omitted.

**Scope paragraph**

3. Reference to “generally accepted auditing standards” is omitted.

4. An auditor obtains reasonable assurance about whether the financial statements are “free of material misstatement,” not “in conformity with generally accepted accounting principles.”

5. The statement that an audit includes “evaluating the overall financial statement presentation” is omitted.

6. The statement that the auditors “believe that our audit provides a reasonable basis for our opinion” is omitted.
Explanatory paragraph

7. The explanatory paragraph should follow the opinion paragraph.

8. The auditors should not give an opinion concerning the entity's survival "beyond a reasonable period of time."

Opinion paragraph

9. A qualified ("subject to") opinion is inappropriate.

10. The date of the financial statements audited is omitted.

11. There should be no reference to consistency unless the accounting principles have not been applied consistently.

M88

Answer 4 (10 points)

Deficiencies in the staff assistant's draft are as follows:

Within the first paragraph

• The statement of cash flow is not identified.
• Standards established by the AICPA, not generally accepted auditing standards, should be referred to.
• The financial statements are not stated to be the representations of management.
• The phrase "our review included such tests of the accounting records as we considered necessary in the circumstances" is inappropriate.

Within the second paragraph

• The phrase "analytical procedures applied to financial data" is omitted.
• The phrase "more in scope than a compilation" is inappropriate.
• An opinion should be disclaimed.
• "Limited assurance" should not be expressed.

Within the third paragraph

• Reference to the "exception" in the third paragraph when it has been restated is inappropriate.
• Reference to consistency is inappropriate.

Within the fourth paragraph

• There should be reference to the prior year's review report.
• There should be reference to generally accepted accounting principles.

M88

Answer 2

b. The accountant's standard report on a compilation of a financial projection should include

• An identification of the projection presented by the responsible party.
• A statement that the accountant has compiled the projection in accordance with standards established by the AICPA.
• A separate paragraph that describes the limitations on the use of the presentation.
• A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the projection or the assumptions.
• A caveat that the prospective results may not be achieved.
• A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

M87

Answer 2 (10 points)

Deficiencies in the staff assistant's draft are as follows:

Within the first paragraph

• The financial statements are not identified by proper names.
• There should be reference to standards established by the AICPA, not Statements on Standards for Auditing and Review Services.
• There is failure to state that the financial statements are the representations of management.

Within the second paragraph

• There is omission of reference to inquiries of company personnel.
• It is inappropriate to state that a review is more in scope than a compilation.
• There is failure to disclaim an opinion.

Within the third paragraph

• Reference should not be made to compilation of the 1985 financial statements.
• The reference to "material modifications" should apply to the 1986 financial statements only, and not to the 1985 financial statements.
• Reference to consistency with the prior year's financial statements should be omitted.
• There is failure to refer to conformity with generally accepted accounting principles.

Within the fourth paragraph

• There is failure to state that a compilation is limited to presenting in the form of financial statements information that is the representation of management.
• There is failure to state that the 1985 financial statements were not audited or reviewed.
• There is omission of proper reference to "any other form of assurance" on the 1985 financial statements.
Business Law

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* No essays were indexed for this group.
† Questions in this area are not classified according to group.
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Content Specification Outlines

CSO-15
MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

N90#1. A CPA firm issues an unqualified opinion on financial statements not prepared in accordance with GAAP. The CPA firm will have acted with scienter in all the following circumstances except where the firm

a. Intentionally disregards the truth.
   b. Has actual knowledge of fraud.
   c. Negligently performs auditing procedures.
   d. Intends to gain monetarily by concealing fraud.

N90#2. A CPA owes a duty to

a. Provide for a successor CPA in the event death or disability prevents completion of an audit.
   b. Advise a client of errors contained in a previously filed tax return.
   c. Disclose client fraud to third parties.
   d. Perform an audit according to GAAP so that fraud will be uncovered.

N90#3. Mell Corp. engaged Davis & Co., CPAs, to audit Mell’s financial statements. Mell’s management informed Davis it suspected that the accounts receivable were materially overstated. Although the financial statements did include a materially overstated accounts receivable balance, Davis issued an unqualified opinion. Mell relied on the financial statements in deciding to obtain a loan from County Bank to expand its operations. County relied on the financial statements in making the loan to Mell. As a result of the overstated accounts receivable balance, Mell has defaulted on the loan and has incurred a substantial loss.

   If County sues Davis for fraud, must Davis furnish County with the audit working papers?

a. Yes, if the working papers are lawfully subpoenaed into court.
   b. Yes, provided that Mell does not object.
   c. No, because of the privileged communication rule, which is recognized in a majority of jurisdictions.
   d. No, because County was not in privity of contract with Davis.

N90#4. In a common law action against an accountant, lack of privity is a viable defense if the plaintiff

a. Can prove the presence of gross negligence which amounts to a reckless disregard for the truth.
   b. Bases the action upon fraud.
   c. Is the client’s creditor who sues the accountant for negligence.
   d. Is the accountant’s client.

N90#5. Mix and Associates, CPAs, issued an unqualified opinion on the financial statements of Glass Corp., for the year ended December 31, 1989. It was determined later that Glass’ treasurer had embezzled $300,000 from Glass during 1989. Glass sued Mix because of Mix’s failure to discover the embezzlement. Mix was unaware of the embezzlement. Which of the following is Mix’s best defense?

a. The audit was performed in accordance with GAAS.
   b. The treasurer was Glass’ agent and, therefore, Glass was responsible for preventing the embezzlement.
   c. The financial statements were presented in conformity with GAAP.
   d. Mix had no actual knowledge of the embezzlement.

N89#1. Krim, President and CEO of United Co., engaged Smith, CPA, to audit United’s financial statements so that United could secure a loan from First Bank. Smith issued an unqualified opinion on May 20, 1988, but the loan was delayed. On August 5, 1988, on inquiry to Smith by First Bank, Smith, relying on Krim’s representation, made assurances that there was no material change in United’s financial status. Krim’s representation was untrue because of a material change which took place after May 20, 1988. First relied on Smith’s assurances of no change. Shortly thereafter, United became insolvent. If First sues Smith for negligent misrepresentation, Smith will be found

a. Not liable, because Krim misled Smith, and a CPA is not responsible for a client’s untrue representations.
   b. Liable, because Smith should have undertaken sufficient auditing procedures to verify the status of United.
   c. Not liable, because Smith’s opinion only covers the period up to May 20.
   d. Liable, because Smith should have contacted the chief financial officer rather than the chief executive officer.
M89#2. If a stockholder sues a CPA for common law fraud based on false statements contained in the financial statements audited by the CPA, which of the following, if present, would be the CPA’s best defense? 
   a. The stockholder lacks privity to sue.
   b. The false statements were immaterial.
   c. The CPA did not financially benefit from the alleged fraud.
   d. The contributory negligence of the client.

M89#5. When CPAs fail in their duty to carry out their contracts for services, liability to clients may be based on 

<table>
<thead>
<tr>
<th>Breach of contract</th>
<th>Strict 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>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

M89#7. Which one of the following, if present, would support a finding of constructive fraud on the part of a CPA?
   a. Privity of contract.
   b. Intent to deceive.
   c. Reckless disregard.
   d. Ordinary negligence.

M89#9. Nast Corp. orally engaged Baker & Co., CPAs, to audit its financial statements. The management of Nast informed Baker that it suspected the accounts receivable were materially overstated. Although the financial statements audited by Baker did, in fact, include a materially overstated accounts receivable balance, Baker issued an unqualified opinion. Nast relied on the financial statements in deciding to obtain a loan from Century Bank to expand its operations. Nast has defaulted on the loan and has incurred a substantial loss.
   If Nast sues Baker for negligence in failing to discover the overstatement, Baker’s best defense would be that
   a. Baker did not perform the audit recklessly or with an intent to deceive.
   b. Baker was not in privity of contract with Nast.
   c. The audit was performed by Baker in accordance with generally accepted auditing standards.
   d. No engagement letter had been signed by Baker.

Business Law

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.
Selected Questions

**N87#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.

**N87#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>

**N87#30.** If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who were unknown to the CPA based on
a. Strict liability.
b. Gross negligence.
c. Negligence.
d. Breach of contract.

**B. Federal Statutory Liability**

**N90#6.** Holly Corp. engaged Yost & Co., CPAs, to audit the financial statements to be included in a registration statement Holly was required to file under the provisions of the Securities Act of 1933. Yost failed to exercise due diligence and did not discover the omission of a fact material to the statements. A purchaser of Holly’s securities may recover from Yost under Section 11 of the Securities Act of 1933 only if the purchaser
a. Brings a civil action within one year of the discovery of the omission and within three years of the offering date.
b. Proves that the registration statement was relied on to make the purchase.
c. Proves that Yost was negligent.
d. Establishes privity of contract with Yost.

**N89#3.** Tax preparers who aid and abet federal tax evasion are subject to

<table>
<thead>
<tr>
<th>Injunction to be prohibited from acting as tax preparers</th>
<th>General federal criminal prosecution</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>

**N89#4.** Brown, CPA, helped Cook organize a partnership that was actually an abusive tax shelter. Brown induced clients to participate by making false statements concerning the allowability of deductions and tax credits. As a result of these activities, Cook derived $100,000 gross income and Brown derived $50,000 gross income. What is Brown’s federal statutory liability under the provision of the Internal Revenue Code specifically relating to promoting abusive tax shelters?

a. $ 10,000  
b. $ 30,000  
c. $ 50,000  
d. $150,000

**N89#8.** Burt, CPA, issued an unqualified opinion on the financial statements of Midwest Corp. These financial statements were included in Midwest’s annual report and Form 10-K filed with the SEC. As a result of Burt’s reckless disregard for GAAS, material misstatements in the financial statements were not detected. Subsequently, Davis purchased stock in Midwest in the secondary market without ever seeing Midwest’s annual report or Form 10-K. Shortly thereafter, Midwest became insolvent and the price of the stock declined dras-
tically. Davis sued Burt for damages based on Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Burt’s best defense is that
a. There has been no subsequent sale for which a loss can be computed.
b. Davis did not purchase the stock as part of an initial offering.
c. Davis did not rely on the financial statements or Form 10-K.
d. Davis was not in privity with Burt.

Gold, CPA, rendered an unqualified opinion on the 1987 financial statements of Eastern Power Co. Egan purchased Eastern bonds in a public offering subject to the Securities Act of 1933. The registration statement filed with the SEC included the financial statements. Gold is being sued by Egan under Section 11 of the Securities Act of 1933 for the misstatements contained in the financial statements. To prevail, Egan must prove valid scienter and reliance.

<table>
<thead>
<tr>
<th>Scienter</th>
<th>Reliance</th>
</tr>
</thead>
</table>
a. No      | No       |
b. No      | Yes      |
c. Yes     | No       |
d. Yes     | Yes      |

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.

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.
Selected Questions

II. Business Organizations

A. Agency

M91#3. Frost's accountant and business manager has the authority to
a. Mortgage Frost's business property.
b. Obtain bank loans for Frost.
c. Insure Frost's property against fire loss.
d. Sell Frost's business.

M91#2. Kent, without authority, contracted to buy computer equipment from Fox Corp. for Ace Corp. Kent told Fox that Kent was acting on Ace's behalf. For Ace to ratify the contract with Fox,
a. Kent must be a general agent of Ace.
b. Ace must know all material facts relating to the contract at the time it is ratified.
c. Ace must notify Fox that Ace intends to ratify the contract.
d. Kent must have acted reasonably and in Ace's best interest.

M91#1. Generally, an agency relationship is terminated by operation of law in all of the following situations except the
a. Principal's death.
b. Principal's incapacity.
c. Agent's renunciation of the agency.
d. Agent's failure to acquire a necessary business license.

M90#2. Pine, an employee of Global Messenger Co., was hired to deliver highly secret corporate documents for Global's clients throughout the world. Unknown to Global, Pine carried a concealed pistol. While Pine was making a delivery, he suspected an attempt was being

C. Workpapers, Privileged Communication, and Confidentiality

N90#9. Locke, CPA, was engaged to perform an audit for Vorst Co. During the audit, Locke discovered that Vorst's inventory contained stolen goods. Vorst was indicted and Locke was validly subpoenaed to testify at the criminal trial. Vorst has claimed accountant-client privilege to prevent Locke from testifying. Locke may be compelled to testify
a. Only with Vorst's consent.
b. In any federal court located in the 50 states.
c. In any state court.
d. Only about the nature of the work performed in the audit.

N90#10. A CPA partnership may, without being lawfully subpoenaed or without the client's consent, make client workpapers available to
a. An individual purchasing the entire partnership.
b. The IRS.
c. The SEC.
d. Any surviving partner(s) on the death of a partner.

M89#5. A CPA is permitted to disclose confidential client information without the consent of the client to
I. Another CPA who has purchased the CPA's tax practice.
II. A successor CPA firm if the information concerns suspected tax return irregularities.
III. A voluntary quality control review board.
   a. I and III only.
b. II and III only.
c. II only.
d. III only.

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.

B.5
made to steal the package, drew his gun and shot Kent, an innocent passerby. Kent will not recover damages from Global if
a. Global discovered that Pine carried a weapon and did nothing about it.
b. Global instructed its messengers not to carry weapons.
c. Pine was correct and an attempt was being made to steal the package.
d. Pine's weapon was unlicensed and illegal.

M90#3. Maco Corp. develops shopping centers and regularly engages real estate brokers to act on its behalf in acquiring parcels of land. The brokers are authorized to enter into such contracts, but are instructed to do so in their own names without disclosing Maco's identity or Maco's relationship to the transaction. If a broker enters into a contract with a seller on Maco's behalf,
a. Maco will be bound by the contract because of the broker's apparent authority.
b. The broker will not be personally bound by the contract because the broker has express authority to act.
c. Maco will not be liable for any negligent acts of the broker committed while acting on Maco's behalf.
d. The broker will have the same authority as if Maco's identity had been disclosed.

M90#4. Able, as agent for Baker, an undisclosed principal, contracted with Safe to purchase an antique car. In payment, Able issued his personal check to Safe. Able could not cover the check but expected Baker to give him cash to deposit before the check was presented for payment. Baker did not do so and the check was dishonored. Baker's identity became known to Safe. Safe may not recover from
b. Able individually on the contract.
c. Baker individually on the check.
d. Able individually on the check.

M90#5. Ace engages Butler to manage Ace's retail business. Butler has the implied authority to do all of the following, except
a. Purchase inventory for Ace's business.
b. Sell Ace's business fixtures.
c. Pay Ace's business debts.
d. Hire or discharge Ace's business employees.

M90#2. A principal will not be liable to a third party for a tort committed by an agent
a. Unless the principal instructed the agent to commit the tort.
b. Unless the tort was committed within the scope of the agency relationship.
c. If the agency agreement limits the principal's liability for the agent's tort.
d. If the tort is also regarded as a criminal act.

M90#3. Parc contracted with Fenn Brothers Corp. to buy hotel furniture and fixtures on behalf of Global Motor House, a motel chain. Global instructed Parc to use Parc's own name and not to disclose to Fenn that Parc was acting on Global's behalf. Who is liable to Fenn on this contract?

<table>
<thead>
<tr>
<th>Parc</th>
<th>Global</th>
</tr>
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<tbody>
<tr>
<td>a. Yes</td>
<td>No</td>
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<td>b. No</td>
<td>Yes</td>
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<td>c. Yes</td>
<td>Yes</td>
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<tr>
<td>d. No</td>
<td>No</td>
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</tbody>
</table>

M90#11. Pell is the principal and Astor is the agent in an agency coupled with an interest. In the absence of a contractual provision relating to the duration of the agency, who has the right to terminate the agency before the interest has expired?

<table>
<thead>
<tr>
<th>Pell</th>
<th>Astor</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<tr>
<td>b. No</td>
<td>Yes</td>
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<tr>
<td>c. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

M90#12. Neal, an employee of Jordan, was delivering merchandise to a customer. On the way, Neal's negligence caused a traffic accident that resulted in damages to a third party's automobile. Who is liable to the third party?

<table>
<thead>
<tr>
<th>Neal</th>
<th>Jordan</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
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<tr>
<td>b. Yes</td>
<td>Yes</td>
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<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>Yes</td>
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</tbody>
</table>

M90#13. Simmons, an agent for Jensen, has the express authority to sell Jensen's goods. Simmons also has the express authority to grant discounts of up to 5% of list price. Simmons sold Hemple goods with a list price of $1,000 and granted Hemple a 10% discount. Hemple had not previously dealt with either Simmons or Jensen. Which of the following courses of action may Jensen properly take?

a. Seek to void the sale to Hemple.
b. Seek recovery of $50 from Hemple only.
c. Seek recovery of $50 from Simmons only.
d. Seek recovery of $50 from either Hemple or Simmons.
Selected Questions

N88#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.

N88#2. Harris is a purchasing agent for Elkin, a sole proprietor. Harris has the express authority to place purchase orders with Elkin's suppliers. Harris typically conducts business through the mail and has very little contact with Elkin. Elkin was incapacitated by a stroke and was declared incompetent in a judicial proceeding. Subsequently, Harris placed an order with Ajax, Inc. on behalf of Elkin. Neither Ajax nor Harris were aware of Elkin's incapacity. With regard to the contract with Ajax, Elkin (or Elkin's legal representative) will
a. Not be liable because Harris was without authority to enter into the contract.
  b. Not be liable provided that Harris had placed orders with Ajax in the past.
  c. Be liable because Harris was acting within the scope of Harris' authority.
  d. Be liable because Ajax was unaware of Elkin's incapacity.

N88#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.

N88#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.

N88#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.

N87#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.

B. Partnerships and Joint Ventures

N90#11. Which of the following is not necessary to create an express partnership?
   a. Execution of a written partnership agreement.
   b. Agreement to share ownership of the partnership.
   c. Intention to conduct a business for profit.
   d. Intention to create a relationship recognized as a partnership.

N90#12. Eller, Fort, and Owens do business as Venture Associates, a general partnership. Trent Corp. brought a breach of contract suit against Venture and Eller individually. Trent won the suit and filed a judgment against both Venture and Eller. Trent will generally be able to collect the judgment from
   a. Partnership assets only.
   b. The personal assets of Eller, Fort, and Owens only.
   c. Eller's personal assets only after partnership assets are exhausted.
   d. Eller's personal assets only.

N90#13. Acorn and Bean were general partners in a farm machinery business. Acorn contracted, on behalf of the partnership, to purchase 10 tractors from Cobb Corp. Unknown to Cobb, Acorn was not authorized by the partnership agreement to make such contracts. Bean refused to allow the partnership to accept delivery of the tractors and Cobb sought to enforce the contract. Cobb will
   a. Lose because Acorn's action was beyond the scope of Acorn's implied authority.
   b. Prevail because Acorn had implied authority to bind the partnership.
   c. Prevail because Acorn had apparent authority to bind the partnership.
   d. Lose because Acorn's express authority was restricted, in writing, by the partnership agreement.

N90#14. Lewis, Clark, and Beal entered into a written agreement to form a partnership. The agreement required that the partners make the following capital contributions: Lewis, $40,000; Clark, $30,000; and Beal, $10,000. It was also agreed that in the event the partnership experienced losses in excess of available capital, Beal would contribute additional capital to the extent of the losses. The partnership agreement was otherwise silent about division of profits and losses. Which of the following statements is correct?
   a. Profits are to be divided among the partners in proportion to their relative capital contributions.
   b. Profits are to be divided equally among the partners.
c. Losses will be allocated in a manner different from the allocation of profits because the partners contributed different amounts of capital.
d. Beal's obligation to contribute additional capital would have an effect on the allocation of profit or loss to Beal.

N89#4. A joint venture is (an)
a. Association limited to no more than two persons in business for profit.
b. Enterprise of numerous co-owners in a non-profit undertaking.
c. Corporate enterprise for a single undertaking of limited duration.
d. Association of persons engaged as co-owners in a single undertaking for profit.

N89#5. Which of the following statements regarding a limited partner is(are) generally correct?

<table>
<thead>
<tr>
<th>The limited partner is subject to personal liability for partnership debts</th>
<th>The limited partner has the right to take part in the control of the partnership</th>
</tr>
</thead>
</table>
a. Yes | Yes |
b. Yes | No |
c. No | Yes |
d. No | No |

N89#6. Gillie, Taft, and Dall are partners in an architectural firm. The partnership agreement is silent about the payment of salaries and the division of profits and losses. Gillie works full-time in the firm, and Taft and Dall each work half-time. Taft invested $120,000 in the firm, and Gillie and Dall invested $60,000 each. Dall is responsible for bringing in 50% of the business, and Gillie and Taft 25% each. How should profits of $120,000 for the year be divided?
a. Gillie $60,000, Taft $30,000, Dall $30,000.
b. Gillie $40,000, Taft $40,000, Dall $40,000.
c. Gillie $30,000, Taft $60,000, Dall $30,000.
d. Gillie $30,000, Taft $30,000, Dall $60,000.

N89#7. A partner's interest in specific partnership property is |Assignable to the partner's individual creditors|Subject to attachment by the partner's individual creditors|
a. Yes | Yes 
b. Yes | No 
c. No | Yes 
d. No | No 

N89#14. Rivers and Lee want to form a partnership. For the partnership agreement to be enforceable, it must be in writing if
a. Rivers and Lee reside in different states.
b. The agreement cannot be completed within one year from the date on which it will be entered into.
c. Either Rivers or Lee is to contribute more than $500 in capital.
d. The partnership intends to buy and sell real estate.

M89#15. Cass is a general partner in Omega Company general partnership. Which of the following unauthorized acts by Cass will bind Omega?
a. Submitting a claim against Omega to arbitration.
b. Confessing a judgment against Omega.
c. Selling Omega's goodwill.
d. Leasing office space for Omega.

M89#16. Kroll, Inc., a partner in JKL Partnership, assigns its interest in the partnership to Trell, who is not made a partner. After the assignment, Trell asserts the rights to
I. Receive Kroll's share of JKL's profits and losses.
II. Inspect JKL's books and records.
Trell is correct as to which of the rights?
a. I only.
b. II only.
c. I and II.
d. Neither I nor II.

M88#4. In general, which of the following statements is correct with respect to a limited partnership?
a. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
b. A limited partnership can be formed with limited liability for all partners.
c. A limited partner may not also be a general partner at the same time.
d. A limited partner may hire employees on behalf of the partnership.

M88#7. Dill was properly admitted as a partner in the ABC Partnership after purchasing Ard's partnership interest. Ard immediately withdrew from the partnership. The partnership agreement states that the partnership will continue on the withdrawal or admission of a partner. Unless the partners otherwise agree,
a. Dill's personal liability for partnership debts incurred before Dill was admitted will be limited to Dill's interest in partnership property.
b. Ard will automatically be released from personal liability for partnership debts incurred before Dill's admission.
c. Ard will be permitted to recover from the other partners the full amount that Ard has paid on account of partnership debts incurred before Dill's admission.
d. Dill will be subjected to unlimited personal liability for partnership debts incurred before being admitted.
M88#13. X, Y, and Z have capital balances of $30,000, $15,000, and $5,000, respectively, in the XYZ Partnership. The general partnership agreement is silent as to the manner in which partnership losses are to be allocated but does provide that partnership profits are to be allocated as follows: 40% to X, 25% to Y, and 35% to Z. The partners have decided to dissolve and liquidate the partnership. After paying all creditors, the amount available for distribution will be $20,000. X, Y, and Z are individually solvent. Under the circumstances, Z will
a. Receive $7,000.
b. Receive $12,000.
c. Personally have to contribute an additional $5,500.
d. Personally have to contribute an additional $5,000.

M88#14. Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to dissolve the partnership. Which of the following statements is correct?
a. Unless Carr consents to a dissolution, Grey must apply to a court and obtain a decree ordering the dissolution.
b. Grey may not dissolve the partnership unless Carr consents.
c. Grey may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.
d. Grey may dissolve the partnership at any time.

M87#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.

M87#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.

M87#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.

M87#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.

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.

M91#6. The limited liability of a stockholder in a closely held corporation may be challenged successfully if the stockholder
   a. Undercapitalized the corporation when it was formed.
   b. Formed the corporation solely to have limited personal liability.
   c. Sold property to the corporation.
   d. Was a corporate officer, director, or employee.

M91#7. A consolidation of two corporations usually requires all of the following except
   a. Approval by the board of directors of each corporation.
   b. Receipt of voting stock by all stockholders of the original corporations.
   c. Provision for an appraisal buyout of dissenting stockholders.
   d. An affirmative vote by the holders of a majority of each corporation’s voting shares.

N90#15. Knox, president of Quick Corp., contracted with Tine Office Supplies, Inc. to supply Quick’s stationery on customary terms and at a cost less than that charged by any other supplier. Knox later informed Quick’s board of directors that Knox was a majority stockholder in Tine. Quick’s contract with Tine is
   a. Void because of Knox’s self-dealing.
   b. Void because the disclosure was made after execution of the contract.
   c. Valid because of Knox’s full disclosure.
   d. Valid because the contract is fair to Quick.

N90#16. A stockholder’s right to inspect books and records of a corporation will be properly denied if the purpose of the inspection is to
   a. Commence a stockholder’s derivative suit.
   b. Obtain stockholder names for a retail mailing list.
   c. Solicit stockholders to vote for a change in the board of directors.
   d. Investigate possible management misconduct.

N90#17. All of the following distributions to stockholders are considered asset or capital distributions, except
   a. Liquidating dividends.
   b. Stock splits.
   c. Property distributions.
   d. Cash dividends.

N90#18. Opal Corp. declared a 9% stock dividend on its common stock. The dividend
   a. Requires a vote of Opal’s stockholders.
   b. Has no effect on Opal’s earnings and profits for federal income tax purposes.
   c. Is includable in the gross income of the recipient taxpayers in the year of receipt.
   d. Must be registered with the SEC pursuant to the Securities Act of 1933.
M90#6. In general, which of the following must be contained in articles of incorporation?
   a. Names of the initial officers and their terms of office.
   b. Classes of stock authorized for issuance.
   c. Names of states in which the corporation will be doing business.
   d. Name of the state in which the corporation will maintain its principal place of business.

M90#7. Absent a specific provision in its articles of incorporation, a corporation's board of directors has the power to do all of the following, except
   a. Repeal the bylaws.
   b. Declare dividends.
   c. Fix compensation of directors.
   d. Amend the articles of incorporation.

M90#8. An owner of common stock will not have any liability beyond actual investment if the owner
   a. Paid less than par value for stock purchased in connection with an original issue of shares.
   b. Agreed to perform future services for the corporation in exchange for original issue par value shares.
   c. Purchased treasury shares for less than par value.
   d. Failed to pay the full amount owed on a subscription contract for no-par shares.

M90#9. Johns owns 400 shares of Abco Corp. cumulative preferred stock. In the absence of any specific provisions in Abco's articles of incorporation, the following statements is correct?
   a. Johns is entitled to convert the 400 shares of preferred stock to a like number of shares of common stock.
   b. If Abco declares a cash dividend on its preferred stock, Johns becomes an unsecured creditor of Abco.
   c. If Abco declares a dividend on its common stock, Johns will be entitled to participate with the common stock shareholders in any dividend distribution made after preferred dividends are paid.
   d. Johns will be entitled to vote if dividend payments are in arrears.

M88#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.

M88#7. The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders
   a. Lend money to the corporation.
   b. Are also corporate officers, directors, or employees.
   c. Undercapitalized the corporation when it was formed.
   d. Formed the corporation solely to limit their personal liability.

M88#15. In general, which of the following statements concerning treasury stock is correct?
   a. A corporation may not reacquire its own stock unless specifically authorized by its articles of incorporation.
   b. On issuance of new stock, a corporation has preemptive rights with regard to its treasury stock.
   c. Treasury stock may be distributed as a stock dividend.
   d. A corporation is entitled to receive cash dividends on its treasury stock.

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.
Selected Questions

D. Estates and Trusts

M91#8. To properly create an inter vivos trust funded with cash, the grantor must
a. Execute a written trust instrument.
b. Transfer the cash to the trustee.
c. Provide for payment of fees to the trustee.
d. Designate an alternate trust beneficiary.

M91#9. Farrel’s will created a testamentary trust naming Gordon as life income beneficiary, with the principal going to Hall on Gordon’s death. The trust’s sole asset was a commercial office building valued at $200,000. The trustee sold the building for $250,000. To what amount of the sale price is Gordon entitled?
   a. $0
   b. $50,000
   c. $200,000
   d. $250,000

M91#10. Mason’s will created a testamentary trust for the benefit of Mason’s spouse. Mason’s sister and Mason’s spouse were named as co-trustees of the trust. The trust provided for discretionary principal distributions to Mason’s spouse. It also provided that, on the death of Mason’s spouse, any remaining trust property was to be distributed to Mason’s children. Part of the trust property consisted of a very valuable coin collection. After Mason’s death, which of the following statements would be correct?
   a. Mason’s spouse may not be a co-trustee because the spouse is also a beneficiary of the trust.
   b. Mason’s sister may delegate her duties as co-trustee to the spouse and thereby not be liable for the administration of the trust.
   c. Under no circumstances could the spouse purchase the coin collection from the trust without breaching fiduciary duties owed to the trust and Mason’s children.
   d. The co-trustees must use the same degree of skill, judgment, and care in managing the trust assets as reasonably prudent persons would exercise in managing their own affairs.

M90#10. Jay properly created an inter vivos trust naming Kroll as trustee. The trust’s sole asset is a fully rented office building. Rental receipts exceed expenditures. The trust instrument is silent about the allocation of items between principal and income. Among the items to be allocated by Kroll during the year are insurance proceeds received as a result of fire damage to the building and the mortgage interest payments made during the year. Which of the following items is(are) properly allocable to principal?

<table>
<thead>
<tr>
<th>Insurance proceeds on building</th>
<th>Current mortgage interest payments</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>

M90#8. Harper transferred assets into a trust under which Drake is entitled to receive the income for life. Upon Drake’s death, the remaining assets are to be paid to Neal. In 1988, the trust received rent of $1,000, royalties of $3,000, cash dividends of $5,000, and proceeds of $7,000 from the sale of stock previously received by the trust as a stock dividend. Both Drake and Neal are still alive. How much of the receipts should be distributed to Drake?
   a. $4,000
   b. $8,000
   c. $9,000
   d. $16,000

M90#17. Generally, an estate is liable for which debts owed by the decedent at the time of death?
   a. All of the decedent’s debts.
   b. Only debts secured by the decedent’s property.
   c. Only debts covered by the statute of frauds.
   d. None of the decedent’s debts.

M90#18. A trust agreement is silent on the allocation of the following trust receipts between principal and income:

- Cash dividends on investments in common stock $1,000
- Royalties from property subject to depletion $2,000

What is the total amount of the trust receipts that should be allocated to trust income?
   a. $0
   b. $1,000
   c. $2,000
   d. $3,000

M90#19. Which of the following expenditures resulting from a trust’s ownership of commercial real estate would be allocated to the trust’s principal?
   a. Sidewalk assessments.
   b. Building management fees.
   c. Real estate taxes.
   d. Electrical repairs.

M90#20. A trust will be terminated if
   a. A beneficiary becomes incompetent.
   b. The trustee dies.
   c. The grantor dies.
   d. The trust term expires.
**Business Law**

**M89#19.** A personal representative of an estate would breach fiduciary duties if the personal representative
a. Combined personal funds with funds of the estate so that both could purchase treasury bills.
b. Represented the estate in a lawsuit brought against it by a disgruntled relative of the decedent.
c. Distributed property in satisfaction of the decedent's debts.
d. Engaged a non-CPA to prepare the records for the estate's final accounting.

**M89#20.** A trust was created in 1980 to provide funds for sending the settlor's child through medical school. The trust agreement specified that the trust was to terminate in 1987. The child entered medical school in 1983, took a leave of absence in 1984, and died in 1986. This trust terminated in
a. 1983
b. 1984
c. 1986
d. 1987

**N88#6.** Krieg's will created a trust to take effect upon Krieg's death. The will named Krieg's spouse as both the trustee and personal representative (executor) of the estate. The will provided that all of Krieg's securities were to be transferred to the trust and named Krieg's child as the beneficiary of the trust. Under the circumstances,
a. Krieg has created a testamentary trust.
b. Krieg's spouse may not serve as both the trustee and personal representative because of the inherent conflict of interest.
c. Krieg has created an inter vivos trust.
d. The trust is invalid because it will not become effective until Krieg's death.

**N88**

**Items 8 and 9** are based on the following:

On January 1, 1988, Dix transferred certain assets into a trust. The assets consisted of Lux Corp. bonds with a face amount of $500,000 and an interest rate of 12%. The trust instrument named Dix as trustee, Dix's child as life beneficiary, and Dix's grandchild as remainderman. Interest on the bonds is payable semi-annually on May 1 and November 1. Dix had purchased the bonds at their face amount. As of January 1, 1988, the bonds had a fair market value of $600,000. The accounting period selected for the trust is a calendar year. The trust instrument is silent as to whether Dix may revoke the trust.

8. Which of the following statements is correct?
a. Dix is not a fiduciary because Dix is also the creator (settlor).
b. The trust is invalid under the merger doctrine because Dix is both the creator and the trustee.
c. A duty is owed by Dix to administer the trust property for the sole benefit of the beneficiaries.
d. Dix has the implied right to revoke the trust without the court's permission.

9. Assuming the trust is valid, how should the amount of interest received in 1988 be allocated between principal and income if the trust instrument is otherwise silent?

<table>
<thead>
<tr>
<th>Principal</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$60,000</td>
</tr>
<tr>
<td>b. $0</td>
<td>$72,000</td>
</tr>
<tr>
<td>c. $10,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>d. $12,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

**M88#10.** To create a valid inter vivos trust to hold personal property, the trust must be
a. In writing and signed by the settlor (creator).
b. Specific concerning the property to be held in trust.
c. Irrevocable.
d. In writing and signed by the trustee.

**M88#12.** Rusk properly created an inter vivos trust naming Gold as the trustee. The sole asset of the trust is an office building that is fully rented. Rental receipts exceed expenditures. The trust instrument is silent as to the allocation of items between principal and income. Which of the following statements is correct concerning Gold's responsibility as trustee?

a. Gold's duty of loyalty will be breached by Gold's purchasing assets from the trust despite a provision in the trust agreement permitting such a purchase.
b. Gold owes a duty of loyalty to the trust but not to the beneficiaries.
c. Gold must exercise reasonable care and skill while performing the duties of a trustee.
d. Gold will be free from personal liability with regard to all contracts entered into by Gold on behalf of the trust absent fraud by Gold.

**N87#16.** On June 16, 1987, Eble placed 800 shares of Singh Corp.'s common stock in a trust for the benefit of Eble's child. On June 1, 1987, Singh's board of directors had declared a cash dividend of $2 per share on Singh's common stock. Payment was made on July 30, 1987, to shareholders of record on June 30, 1987. What amount of the dividend should be allocated to trust income?

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
</tr>
<tr>
<td>b. $800</td>
</tr>
<tr>
<td>c. $1,200</td>
</tr>
<tr>
<td>d. $1,600</td>
</tr>
</tbody>
</table>

**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
Selected Questions

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.

III. Contracts

A. Offer and Acceptance

M91#11. Nix sent Castor a letter offering to employ Castor as controller of Nix’s automobile dealership. Castor received the letter on February 19. The letter provided that Castor would have until February 23 to consider the offer and, in the meantime, Nix would not withdraw it. On February 20, Nix, after reconsidering the offer to Castor, decided to offer the job to Vick, who accepted immediately. That same day, Nix called Castor and revoked the offer. Castor told Nix that an acceptance of Nix’s offer was mailed on February 19. Under the circumstances,
   a. Nix’s offer was irrevocable until February 23.
   b. No contract was formed between Nix and Castor because Nix revoked the offer before Nix received Castor’s acceptance.
   c. Castor’s acceptance was effective when mailed.
   d. Any revocation of the offer would have to be in writing because Nix’s offer was in writing.

M91#12. Carson Corp., a retail chain, asked Alto Construction to fix a broken window at one of Carson’s stores. Alto offered to make the repairs within three days at a price to be agreed on after the work was completed. A contract based on Alto’s offer would fail because of indefiniteness as to the
   a. Price involved.
   b. Nature of the subject matter.
   c. Parties to the contract.
   d. Time for performance.

M90#13. On November 1, Yost sent a telegram to Zen offering to sell a rare vase. The offer required that Zen’s acceptance telegram be sent on or before 5:00 P.M. on November 2. On November 2, at 3:00 P.M., Zen sent an acceptance by overnight mail. It did not reach Yost until November 5. Yost refused to complete the sale to Zen. Is there an enforceable contract?
   a. Yes, because the acceptance was made within the time specified.
   b. Yes, because the acceptance was effective when sent.
   c. No, because Zen did not accept by telegram.
   d. No, because the offer required receipt of the acceptance within the time specified.

M90#14. Opal offered, in writing, to sell Larkin a parcel of land for $300,000. If Opal dies, the offer will
   a. Terminate prior to Larkin’s acceptance only if Larkin received notice of Opal’s death.
   b. Remain open for a reasonable period of time after Opal’s death.
   c. Automatically terminate despite Larkin’s prior acceptance.
   d. Automatically terminate prior to Larkin’s acceptance.

M89#9. The mailbox rule generally makes acceptance of an offer effective at the time the acceptance is dispatched. The mailbox rule does not apply if
   a. Both the offeror and offeree are merchants.
   b. The offer proposes a sale of real estate.
   c. The offer provides that an acceptance shall not be effective until actually received.
   d. The duration of the offer is not in excess of three months.

M89#21. Martin wrote Dall and offered to sell Dall a building for $200,000. The offer stated it would expire 30 days from April 1. Martin changed his mind and does not wish to be bound by his offer. If a legal dispute arises between the parties regarding whether there has
been a valid acceptance of the offer, which one of the following is correct?

a. The offer cannot be legally withdrawn for the stated period of time.
b. The offer will not expire before the 30 days even if Martin sells the property to a third person and notifies Dall.
c. If Dall categorically rejects the offer on April 10, Dall cannot validly accept within the remaining stated period of time.
d. If Dall phoned Martin on May 3, and unequivocally accepted the offer, a contract would be created, provided that Dall had no notice of withdrawal of the offer.

M88#22. Which of the following statements concerning the effectiveness of an offeree's rejection and an offeror's revocation of an offer is generally correct?

<table>
<thead>
<tr>
<th>An offeree's rejection is effective when</th>
<th>An offeror's revocation is effective when</th>
</tr>
</thead>
<tbody>
<tr>
<td>Received by offeror</td>
<td>Sent by offeror</td>
</tr>
<tr>
<td>Sent by offeree</td>
<td>Received by offeree</td>
</tr>
<tr>
<td>Sent by offeror</td>
<td>Sent by offeror</td>
</tr>
<tr>
<td>Received by offeror</td>
<td>Received by offeror</td>
</tr>
</tbody>
</table>

M88#23. An offer is not terminated by operation of law solely because the

a. Offeror dies.
b. Offeree is adjudicated insane.
c. Subject matter is destroyed.
d. Subject matter is sold to a third party.

M88#25. To announce the grand opening of a new retail business, Hudson placed an advertisement in a local newspaper quoting sales prices on certain items in stock. The grand opening was so successful that Hudson was unable to totally satisfy customer demands. Which of the following statements is correct?

a. Hudson made an invitation seeking offers.
b. Hudson made an offer to the people who read the advertisement.
c. Anyone who tendered money for the items advertised was entitled to buy them.
d. The offer by Hudson was partially revocable as to an item once it was sold out.

M88#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.

M88 Items 11 and 12 are based on the following:

On April 2, Jet Co. wrote to Ard, offering to buy Ard's building for $350,000. The offer contained all of the essential terms to form a binding contract and was duly signed by Jet's president. It further provided that the offer would remain open until May 30 and an acceptance would not be effective until received by Jet. On April 10, Ard accepted Jet's offer by mail. The acceptance was received by Jet on April 14.

11. For this item only, assume that on April 11 Jet sent a telegram to Ard revoking its offer and that Ard received the telegram on April 12. Under the circumstances,

a. A contract was formed on April 10.
b. A contract was formed on April 14.
c. Jet's revocation effectively terminated its offer on April 12.
d. Jet's revocation effectively terminated its offer on April 11.

12. For this item only, assume that on April 13 Ard sent a telegram to Jet withdrawing the acceptance and rejecting Jet's offer and that Jet received the telegram on April 15. Under the circumstances,

a. A contract was formed on April 14.
b. A contract was formed on April 10.
c. Ard's rejection effectively terminated Jet's offer on April 13.
d. Ard's rejection effectively terminated Jet's offer on April 15.

M88#16. In order for an offer to confer the power to form a contract by acceptance, it must have all of the following elements except

a. Be communicated to the offeree and the communication must be made or authorized by the offeror.
b. Be sufficiently definite and certain.
c. Be communicated by words to the offeree by the offeror.
d. Manifest an intent to enter into a contract.

M88#17. On July 1, Silk, Inc., sent Blue a telegram offering to sell Blue a building for $80,000. In the telegram, Silk stated that it would give Blue 30 days to accept the offer. On July 15, Blue sent Silk a telegram that included the following statement: "The price for your building seems too high. Would you consider taking $75,000?" This telegram was received by Silk on July 16. On July 19, Tint made an offer to Silk to purchase the building for $82,000. Upon learning of Tint's offer, Blue, on July 27, sent Silk a signed letter agreeing to purchase the building for $80,000. This letter was received by Silk on July 29. However, Silk now refuses to sell Blue the building. If Blue commences an action against Silk for breach of contract, Blue will

a. Win, because Blue effectively accepted Silk's offer of July 1.
b. Win, because Silk was obligated to keep the offer open for the 30-day period.
c. Lose, because Blue sent the July 15 telegram.
d. Lose, because Blue used an unauthorized means of communication.

M87#11. On April 2, 1987, Bonn & Co., CPAs, mailed Marble Corp. a signed proposal to perform certain accounting services for Marble provided Marble accepts the proposal by April 30, 1987. Under the circumstances,
   a. If Marble accepts by telephone on April 30, 1987, no contract will be formed between the parties.
   b. Marble must accept the Bonn proposal in writing in order to form a contract.
   c. A contract will be formed between the parties if Marble mails an acceptance to Bonn on April 29, 1987, even if it is not received by Bonn until May 3, 1987.
   d. Bonn may not withdraw its proposal prior to May 1, 1987.

M87
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.

B. Consideration

M91#16. Kay, an art collector, promised Hammer, an art student, that if Hammer could obtain certain rare artifacts within two weeks, Kay would pay for Hammer's postgraduate education. At considerable effort and expense, Hammer obtained the specified artifacts within the two-week period. When Hammer requested payment, Kay refused. Kay claimed that there was no consideration for the promise. Hammer would prevail against Kay based on
   a. Unilateral contract.
   b. Unjust enrichment.
   c. Public policy.
   d. Quasi contract.

N90#21. Which of the following requires consideration to be binding on the parties?
   a. Material modification of a contract involving the sale of real estate.
   b. Ratification of a contract by a person after reaching the age of majority.
   c. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
   d. Material modification of a sale of goods contract under the UCC.

M90#11. To satisfy the consideration requirement for a valid contract, the consideration exchanged by the parties must be
   a. Legally sufficient.
   b. Payable in legal tender.
   c. Simultaneously paid and received.
   d. Of the same economic value.

M90#16. Which of the following will be legally binding on all parties despite lack of consideration?
   a. An irrevocable oral promise by a merchant to keep an offer open for 60 days.
   b. A promise to donate money to a charity which the charity relied upon in incurring large expenditures.
   c. A promise to pay for the college education of the child of a person who saved the promisor's life.
   d. A signed modification to a contract to purchase a parcel of land.

N89#10. For there to be consideration for a contract, there must be
   a. A bargained-for detriment to the promisor(see) or a benefit to the promisee(or).
   b. A manifestation of mutual assent.
   c. Genuineness of assent.
   d. Substantially equal economic benefits to both parties.

M89#24. Dye sent Hill a written offer to sell a tract of land located in Newtown for $60,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Hill would
promise to refrain from suing Dye during this time. Hill promptly delivered a promise not to sue during the term of the offer and to forego suit if Hill accepted the offer. Dye subsequently decided that the possible suit by Hill was groundless and therefore phoned Hill and revoked the offer 15 days after making it. Hill mailed an acceptance on the 20th day. Dye did not reply. Under the circumstances,

a. Dye’s offer was supported by consideration and was not revocable when accepted.
b. Dye’s written offer would be irrevocable even without consideration.
c. Dye’s silence was an acceptance of Hill’s promise.
d. Dye’s revocation, not being in writing, was invalid.

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.

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.

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.

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.

On reaching majority, a minor may ratify a contract in any of the following ways except by

a. Failing to disaffirm within a reasonable time after reaching majority.
b. Orally ratifying the entire contract.
c. Acting in a manner that amounts to ratification.
d. Affirming, in writing, some of the terms of the contract.

Which of the following would be unenforceable because the subject matter is illegal?

a. A contingent fee charged by an attorney to represent a plaintiff in a negligence action.
b. An arbitration clause in a supply contract.
c. A restrictive covenant in an employment contract prohibiting a former employee from using the employer’s trade secrets.
d. An employer’s promise not to press embezzlement charges against an employee who agrees to make restitution.

Payne entered into a written agreement to sell a parcel of land to Stevens. At the time the agreement was executed, Payne had consumed alcoholic beverages. Payne’s ability to understand the nature and terms of the contract was not impaired. Stevens did not believe that Payne was intoxicated. The contract is

a. Void as a matter of law.
b. Legally binding on both parties.
c. Voidable at Payne’s option.
d. Voidable at Stevens’ option.

Kent, a 16-year old, purchased a used car from Mint Motors, Inc. Ten months later, the car was stolen and never recovered. Which of the following statements is correct?

a. The car’s theft is a de facto ratification of the purchase because it is impossible to return the car.
b. Kent may disaffirm the purchase because Kent is a minor.
c. Kent effectively ratified the purchase because Kent used the car for an unreasonable period of time.
d. Kent may disaffirm the purchase because Mint, a merchant, is subject to the UCC.

Tell, an Ohio real estate broker, misrepresented to Allen that Tell was licensed in Michigan under Michigan’s statute regulating real estate brokers. Allen
signed a standard form listing contract agreeing to pay Tell a 6% commission for selling Allen's home in Michigan. Tell sold Allen's home. Under the circumstances, Allen is

a. Not liable to Tell for any amount because Allen signed a standard form contract.
b. Not liable to Tell for any amount because Tell violated the Michigan licensing requirements.
c. Liable to Tell only for the value of services rendered under a quasi-contract theory.
d. Liable to Tell for the full commission under a promissory estoppel theory.

M88#13. Parr is the vice-president of research of Lynx, Inc. When hired, Parr signed an employment contract prohibiting Parr from competing with Lynx during and after employment. While employed, Parr acquired knowledge of many of Lynx’s trade secrets. If Parr wishes to compete with Lynx and Lynx refuses to give Parr permission, which of the following statements is correct?

a. Parr has the right to compete with Lynx upon resigning from Lynx.
b. Parr has the right to compete with Lynx only if fired from Lynx.
c. In determining whether Parr may compete with Lynx, the court should not consider Parr’s ability to obtain other employment.
d. In determining whether Parr may compete with Lynx, the court should consider, among other factors, whether the agreement is necessary to protect Lynx’s legitimate business interests.

M88#19. Parr is a CPA licensed to practice in State A. Parr entered into a contract with Jet, Inc., to perform an audit in State B for $50,000 (including expenses). After Parr had satisfactorily performed the audit, Jet discovered that Parr had violated State B’s licensing statute by failing to obtain a CPA license in State B. Parr incurred $10,000 in expenses in connection with the audit. Jet refuses to pay any fee to Parr, arguing that it could have engaged a local CPA licensed in State B to perform the same services for $35,000 (including expenses). If Parr sues Jet based on breach of contract, Parr will be entitled to recover a maximum of

a. $0
b. $10,000
c. $35,000
d. $50,000

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.

D. Statute of Frauds

M91#14. Nolan agreed orally with Train to sell Train a house for $100,000. Train sent Nolan a signed agreement and a down payment of $10,000. Nolan did not sign the agreement, but allowed Train to move into the house. Before closing, Nolan refused to go through with the sale. Train sued Nolan to compel specific performance. Under the provisions of the Statute of Frauds, a. Train will win because Train signed the agreement and Nolan did not object.
b. Train will win because Train made a down payment and took possession.
c. Nolan will win because Nolan did not sign the agreement.
d. Nolan will win because the house was worth more than $500.

M91#17. Bond and Spear orally agreed that Bond would buy a car from Spear for $475. Bond paid Spear a $100 deposit. The next day, Spear received an offer of $575, the car’s fair market value. Spear immediately notified Bond that Spear would not sell the car to Bond and returned Bond’s $100. If Bond sues Spear and Spear defends on the basis of the statute of frauds, Bond will probably

a. Lose, because the agreement was for less than the fair market value of the car.
b. Win, because the agreement was for less than $500.
c. Lose, because the agreement was not in writing and signed by Spear.
d. Win, because Bond paid a deposit.

M90#15. King sent Foster, a real estate developer, a signed offer to sell a specified parcel of land to Foster for $200,000. King, an engineer, had inherited the land. On the same day that King’s letter was received, Foster telephoned King and accepted the offer. Which of the following statements is correct under the Statute of Frauds?

a. No contract was formed because Foster did not sign the offer.
b. No contract was formed because King is not a merchant and, therefore, King’s letter is not binding on Foster.
c. A contract was formed, although it would be enforceable only against King.
d. A contract was formed and would be enforceable against both King and Foster because Foster is a merchant.
With regard to an agreement for the sale of real estate, the Statute of Frauds
a. Does not require that the agreement be signed by all parties.
b. Does not apply if the value of the real estate is less than $500.
c. Requires that the entire agreement be in a single writing.
d. Requires that the purchase price be fair and adequate in relation to the value of the real estate.

The Statute of Frauds
a. Prevents the use of oral evidence to contradict the terms of a written contract.
b. Applies to all contracts having consideration valued at $500 or more.
c. Requires the independent promise to pay the debt of another to be in writing.
d. Applies to all real estate leases.

Able hired Carr to restore Able's antique car for $800. The terms of their oral agreement provided that Carr was to complete the work within 18 months. Actually, the work could be completed within one year. The agreement is
a. Unenforceable because it covers services with a value in excess of $500.
b. Unenforceable because it covers a time period in excess of one year.
c. Enforceable because personal service contracts are exempt from the Statute of Frauds.
d. Enforceable because the work could be completed within one year.

To satisfy the UCC Statute of Frauds, a written agreement for the sale of goods must
a. Contain payment terms.
b. Be signed by both buyer and seller.
c. Indicate that a contract for sale has been made.
d. Refer to the time and place of delivery.

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.

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.

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.

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.

E. Statute of Limitations

In 1959, Dart bought an office building from Graco under a written contract signed only by Dart. In 1991, Dart discovered that Graco made certain false representations during their negotiations concerning the building's foundation. Dart could have reasonably discovered the foundation problems by 1963. Dart sued Graco claiming fraud in the formation of the contract. Which of the following statements is correct?
a. The parol evidence rule will prevent the admission into evidence of proof concerning Dart's allegations.
b. Dart will be able to rescind the contract because both parties did not sign it.
c. Dart must prove that the alleged misrepresentations were part of the written contract because the contract involved real estate.
d. The statute of limitations would likely prevent Dart from prevailing because of the length of time that has passed.

**N89#13.** Unless the parties have otherwise agreed, an action for the breach of a contract within the UCC Sales Article must be commenced within

a. Four years after the cause of action has accrued.
b. Six years after the cause of action has accrued.
c. Four years after the effective date of the contract.
d. Six years after the effective date of the contract.

**M88#22.** On May 1, 1972, Mix, CPA, entered into an oral contract with Dell to provide certain accounting services to Dell. The contract was fully performed by both parties in 1974. On April 25, 1988, Dell commenced a breach of contract action against Mix claiming that Mix had improperly performed the accounting services. Mix's best defense to the action would likely be the

a. Parol evidence rule.
b. Statute of limitations.
c. Statute of frauds.
d. Lack of consideration.

### F. Fraud, Duress, and Undue Influence

**M91#20.** Johns leased an apartment from Olsen. Shortly before the lease expired, Olsen threatened Johns with eviction and physical harm if Johns did not sign a new lease for twice the old rent. Johns, unable to afford the expense to fight eviction, and in fear of physical harm, signed the new lease. Three months later, Johns moved and sued to void the lease claiming duress. The lease will be held

a. Void because of the unreasonable increase in rent.
b. Voidable because of Olsen's threat to bring eviction proceedings.
c. Void because of Johns' threat of physical harm.
d. Voidable because of Olsen's threat of physical harm.

**N90#23.** For a purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats

a. Constituted a crime or tort.
b. Would have induced a reasonably prudent person to assent to the contract.
c. Actually induced the purchaser to assent to the contract.
d. Were made with the intent to influence the purchaser.

**M90#21.** Steele, Inc. wanted to purchase Kalp's distribution business. On March 15, 1990, Kalp provided Steele with copies of audited financial statements for the period ended December 31, 1989. The financial statements reflected inventory in the amount of $1,200,000. On March 29, 1990, Kalp discovered that the December 31 inventory was overstated by at least $400,000. On April 3, 1990, Steele, relying on the financial statements, purchased all of Kalp's business. On April 29, 1990, Steele discovered the inventory overstatement. Steele sued Kalp for fraud. Which of the following statements is correct?

a. Steele will lose because it should not have relied on the inventory valuation in the financial statements.
b. Steele will lose because Kalp was unaware that the inventory valuation was incorrect at the time the financial statements were provided to Steele.
c. Steele will prevail because Kalp had a duty to disclose the fact that the inventory value was overstated.
d. Steele will prevail but will not be able to sue for damages.

**N88#14.** Bradford sold a parcel of land to Jones who promptly recorded the deed. Bradford then resold the land to Wallace. In a suit against Bradford by Wallace, recovery will be based on the theory of

a. Bilateral mistake.
b. Ignorance of the facts.
c. Unilateral mistake.
d. Fraud.

**M98#28.** King had several outstanding unsecured loans with National Bank. In addition, King had a separate loan with National that was secured by a mortgage on a farm owned by King. King was delinquent on the mortgage loan but not on the unsecured loans. National asked King to sign renewal notes for the unsecured loans at substantially higher interest rates. When King refused, National informed King that it would foreclose on the farm's mortgage if King did not sign. King signed but later disaffirmed the new unsecured notes and National sued. King's best defense is

a. Undue influence.
b. Unconscionability.
c. Duress.
d. Fraud in the inducement.

**N88#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.
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.

d. The contract between Paco and Preston is void because the price set forth in the offer is substantially less than the equipment's fair market value.

N89#15. A party to a contract who seeks to rescind the contract because of that party's reliance on the unintentional but materially false statements of the other party will assert
   a. Reformation.
   b. Actual fraud.
   c. Misrepresentation.
   d. Constructive fraud.

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.

G. Mistake and Misrepresentation

M91#21. To prevail in a common law action for innocent misrepresentation, the plaintiff must prove
   a. The defendant made the false statements with a reckless disregard for the truth.
   b. The misrepresentations were in writing.
   c. The misrepresentations concerned material facts.
   d. Reliance on the misrepresentations was the only factor inducing the plaintiff to enter into the contract.

M90#23. Paco Corp., a building contractor, offered to sell Preston several pieces of used construction equipment. Preston was engaged in the business of buying and selling equipment. Paco's written offer had been prepared by a secretary who typed the total price as $10,900, rather than $109,000, which was the approximate fair market value of the equipment. Preston, on receipt of the offer, immediately accepted it. Paco learned of the error in the offer and refused to deliver the equipment to Preston unless Preston agreed to pay $109,000. Preston has sued Paco for breach of contract. Which of the following statements is correct?
   a. Paco will not be liable because there has been a mutual mistake of fact.
   b. Paco will be able to rescind the contract because Preston should have known that the price was erroneous.
   c. Preston will prevail because Paco is a merchant.

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. Lile, 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.

H. Parol Evidence Rule

M89#18. Dunne and Cook signed a contract requiring Cook to rebind 500 of Dunne’s books at 80¢ per book. Later, Dunne requested, in good faith, that the price be reduced to 70¢ per book. Cook agreed orally to reduce the price to 70¢. Under the circumstances, the oral agreement is
  a. Enforceable, but proof of it is inadmissible into evidence.
  b. Enforceable, and proof of it is admissible into evidence.
  c. Unenforceable, because Dunne failed to give consideration, and proof of it is otherwise inadmissible into evidence.
  d. Unenforceable, due to the statute of frauds, and proof of it is inadmissible into evidence.

M89#16. Ward is attempting to introduce oral evidence in an action relating to a written contract between Ward and Weaver. Weaver has pleaded the parol evidence rule. Ward will be prohibited from introducing parol evidence if it relates to
  a. A modification made several days after the contract was executed.
  b. A change in the meaning of an unambiguous provision in the contract.
  c. Fraud in the inducement.
  d. An obvious error in drafting.

M89#31. A written agreement was signed by two parties and it was intended to be their entire agreement. The parol evidence rule will prevent the admission of evidence that is offered to
  a. Prove the existence of a contemporaneous oral agreement that modifies the contract.
  b. Prove the existence of a subsequent oral agreement that modifies the contract.
  c. Explain the meaning of an ambiguity in the written contract.
  d. Establish that fraud had been committed in the formation of the contract.

M88#21. Baker and Able signed a contract which required Able to purchase 600 books from Baker at 90¢ per book. Subsequently, Able, in good faith, requested that the price of the books be reduced to 80¢ per book. Baker orally agreed to reduce the price to 80¢. Under the circumstances, the oral agreement is
  a. Unenforceable, because Able failed to give consideration, but proof of it will be otherwise admissible into evidence.
  b. Unenforceable, due to the statute of frauds, and proof of it will be inadmissible into evidence.
  c. Enforceable, but proof of it will be inadmissible into evidence.
  d. Enforceable, and proof of it will be admissible into evidence.

I. Third Party Rights

M91#19. Wilk bought an apartment building from Dix Corp. There was a mortgage on the building securing Dix’s promissory note to Xeon Finance Co. Wilk took title subject to Xeon’s mortgage. Wilk did not make the payments on the note due Xeon and the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct regarding the deficiency?
  a. Xeon must attempt to collect the deficiency from Wilk before suing Dix.
  b. Dix will not be liable for any of the deficiency because Wilk assumed the note and mortgage.
  c. Xeon may collect the deficiency from either Dix or Wilk.
  d. Dix will be liable for the entire deficiency.

M91#22. Graham contracted with the city of Harris to train and employ high school dropouts residing in Harris. Graham breached the contract. Long, a resident of Harris and a high school dropout, sued Graham for damages. Under the circumstances, Long will
  a. Win, because Long is a third-party beneficiary entitled to enforce the contract.
  b. Win, because the intent of the contract was to confer a benefit on all high school dropouts residing in Harris.
  c. Lose, because Long is merely an incidental beneficiary of the contract.
  d. Lose, because Harris did not assign its contract rights to Long.

N90#24. Omega Corp. owned a factory that was encumbered by a mortgage securing Omega’s note to Eagle Bank. Omega sold the factory to Spear, Inc., which assumed the mortgage note. Later, Spear defaulted on the note, which had an outstanding balance of $15,000. To recover the outstanding balance, Eagle
  a. May sue Spear only after suing Omega.
  b. May sue either Spear or Omega.
  c. Must sue both Spear and Omega.
  d. Must sue Spear first and then proceed against Omega for any deficiency.
M90#19. Union Bank lent $200,000 to Wagner. Union required Wagner to obtain a life insurance policy naming Union as beneficiary. While the loan was outstanding, Wagner stopped paying the premiums on the policy. Union paid the premiums, adding the amounts paid to Wagner’s loan. Wagner died and the insurance company refused to pay the policy proceeds to Union. Union may
   a. Recover the policy proceeds because it is a creditor beneficiary.
   b. Recover the policy proceeds because it is a donee beneficiary.
   c. Not recover the policy proceeds because it is not in privyty of contract with the insurance company.
   d. Not recover the policy proceeds because it is only an incidental beneficiary.

M90#24. Rice contracted with Locke to build an oil refinery for Locke. The contract provided that Rice was to use United pipe fittings. Rice did not do so. United learned of the contract and, anticipating the order, manufactured additional fittings. United sued Locke and Rice. United is
   a. Entitled to recover from Rice only, because Rice breached the contract.
   b. Entitled to recover from either Locke or Rice because it detrimentally relied on the contract.
   c. Not entitled to recover because it is a donee beneficiary.
   d. Not entitled to recover because it is an incidental beneficiary.

N88#17. Jones owned an insurance policy on her life, on which she paid all the premiums. Smith was named the beneficiary. Jones died and the insurance company refused to pay the policy proceeds to Smith. An action by Smith against the insurance company for the insurance proceeds will be
   a. Successful because Smith is a third party donee beneficiary.
   b. Successful because Smith is a proper assignee of Jones’ rights under the insurance policy.
   c. Unsuccessful because Smith was not the owner of the policy.
   d. Unsuccessful because Smith did not pay any of the premiums.

M89#32. Ace contracted with Big City to train and employ handicapped, unemployed veterans residing in Big City. Ace breached the contract and Bell, a resident of Big City who is a handicapped, unemployed veteran, sues Ace for damages. Under the circumstances, Bell will
   a. Lose, because Bell is merely an incidental beneficiary of the contract.
   b. Win, because Bell is a third-party beneficiary entitled to enforce the contract.
   c. Lose, because Big City did not assign its contract rights to Bell.
   d. Win, because the intent of the contract was to confer a benefit on all handicapped, unemployed veterans residing in Big City.

N88#17. Bond purchased from Spear Corp. an apartment building that was encumbered by a mortgage securing Spear’s promissory note to Fale Finance Co. Bond assumed Spear’s note and mortgage. Subsequently, Bond defaulted on the note payable to Fale and, as a result, the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct?
   a. Fale must sue both Spear and Bond to collect the deficiency because they are jointly and severally liable.
   b. Spear will be liable for the deficiency.
   c. Fale must attempt to collect the deficiency from Bond before suing Spear.
   d. Spear will not be liable for the deficiency because Bond assumed the note and mortgage.

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, Krieg was automatically released from any liability on the note.

J. Assignments

M91#28. One of the criteria for a valid assignment of a sales contract to a third party is that the assignment must
   a. Not materially increase the other party’s risk or duty.
   b. Not be revocable by the assignor.
   c. Be supported by adequate consideration from the assignee.
   d. Be in writing and signed by the assignor.

M90#22. On August 1, Neptune Fisheries contracted in writing with West Markets to deliver to West 3,000 pounds of lobsters at $4.00 a pound. Delivery of the lobsters was due October 1 with payment due November 1. On August 4, Neptune entered into a contract with Deep Sea Lobster Farms which provided as follows: “Neptune Fisheries assigns all the rights under the contract with West Markets dated August 1 to Deep Sea Lobster Farms.” The best interpretation of the August 4 contract would be that it was
   a. Only an assignment of rights by Neptune.
   b. Only a delegation of duties by Neptune.
   c. An assignment of rights and a delegation of duties by Neptune.
   d. An unenforceable third-party beneficiary contract.
Selected Questions

N89#18. Moss entered into a contract to purchase certain real property from Shinn. Which of the following statements is not correct?
   a. If Shinn fails to perform the contract, Moss can obtain specific performance.
   b. The contract is nonassignable as a matter of law.
   c. The Statute of Frauds applies to the contract.
   d. Any amendment to the contract must be agreed to by both Moss and Shinn.

N89#33. Generally, which one of the following transfers will be valid without the consent of the other parties?
   a. The assignment by the lessee of a lease contract where rent is a percentage of sales.
   b. The assignment by a purchaser of goods of the right to buy on credit without giving security.
   c. The assignment by an architect of a contract to design a building.
   d. The assignment by a patent holder of the right to receive royalties.

N88#19. 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.

N88#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.

N87#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.

K. Discharge, Breach, and Remedies

M91#23. Maco Corp. contracted to sell 1,500 bushels of potatoes to LBC Chips. The contract did not refer to any specific supply source for the potatoes. Maco intended to deliver potatoes grown on its farms. An insect infestation ruined Maco’s crop but not the crops of other growers in the area. Maco failed to deliver the potatoes to LBC. LBC sued Maco for breach of contract. Under the circumstances, Maco will
   a. Lose, because it could have purchased potatoes from other growers to deliver to LBC.
   b. Lose, unless it can show that the purchase of substitute potatoes for delivery to LBC would make the contract unprofitable.
   c. Win, because the infestation was an act of nature that could not have been anticipated by Maco.
   d. Win, because both Maco and LBC are assumed to accept the risk of a crop failure.

M91#24. In general, a clause in a real estate contract entitling the seller to retain the purchaser’s down payment as liquidated damages if the purchaser fails to close the transaction, is enforceable
   a. In all cases, when the parties have a signed contract.
   b. If the amount of the down payment bears a reasonable relationship to the probable loss.
   c. As a penalty, if the purchaser intentionally defaults.
   d. Only when the seller cannot compel specific performance.

N90#25. Parc hired Glaze to remodel and furnish an office suite. Glaze submitted plans that Parc approved. After completing all the necessary construction and painting, Glaze purchased minor accessories that Parc rejected because they did not conform to the plans. Parc refused to allow Glaze to complete the project and
refused to pay Glaze any part of the contract price. Glaze sued for the value of the work performed. Which of the following statements is correct?

a. Glaze will lose because Glaze breached the contract by not completing performance.
b. Glaze will win because Glaze substantially performed and Parc prevented complete performance.
c. Glaze will lose because Glaze materially breached the contract by buying the accessories.
d. Glaze will win because Parc committed anticipatory breach.

Mr9\#25. Wren purchased a factory from First Federal Realty. Wren paid 20% at the closing and gave a note for the balance secured by a 20-year mortgage. Five years later, Wren found it increasingly difficult to make payments on the note and defaulted. First Federal threatened to accelerate the loan and foreclose if Wren continued in default. First Federal told Wren to make payment or obtain an acceptable third party to assume the obligation. Wren offered the land to Moss, Inc. for $10,000 less than the equity Wren had in the property. This was acceptable to First Federal and at the closing Moss paid the arrearage, assumed the mortgage and note, and had title transferred to its name. First Federal released Wren. The transaction in question is a(an)

a. Purchase of land subject to a mortgage.
b. Assignment and delegation.
c. Third party beneficiary contract.
d. Novation.

Mr9\#19. Nagel and Fields entered into a contract in which Nagel was obligated to deliver certain goods to Fields by September 10. On September 3, Nagel told Fields that Nagel had no intention of delivering the goods required by the contract. Prior to September 10, Fields may successfully sue Nagel under the doctrine of

a. Promissory estoppel.
b. Accord and satisfaction.
c. Anticipatory repudiation.
d. Substantial performance.

Mr9\#34. In September 1988, Cobb Company contracted with Thrifty Oil Company for the delivery of 100,000 gallons of heating oil at the price of 75¢ per gallon at regular specified intervals during the forthcoming winter. Due to an unseasonably warm winter, Cobb took delivery on only 70,000 gallons. In a suit against Cobb for breach of contract, Thrifty will

a. Lose, because Cobb acted in good faith.
b. Lose, because both parties are merchants and the UCC recognizes commercial impracticability.
c. Win, because this is a requirements contract.
d. Win, because the change of circumstances could have been contemplated by the parties.

Mr9\#35. Jones, CPA, entered into a signed contract with Foster Corp. to perform accounting and review services. If Jones repudiates the contract prior to the date performance is due to begin, which of the following is not correct?

a. Foster could successfully maintain an action for breach of contract after the date performance was due to begin.
b. Foster can obtain a judgment ordering Jones to perform.
c. Foster could successfully maintain an action for breach of contract prior to the date performance is due to begin.
d. Foster can obtain a judgment for the monetary damages it incurred as a result of the repudiation.

Mr8\#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.

Mr8\#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.

Mr7\#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.

**M91#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.

**IV. Debtor-Creditor Relationships**

**A. Suretyship**

**M91#25.** Which of the following events will release a noncompensated surety from liability?

a. Filing of an involuntary petition in bankruptcy against the principal debtor.
b. Insanity of the principal debtor at the time the contract was entered into with the creditor.
c. Release of the principal debtor's obligation by the creditor but with the reservation of the creditor's rights against the surety.
d. Modification by the principal debtor and creditor of their contract that materially increases the surety's risk of loss.

**M91#26.** Edwards Corp. lent Lark $200,000. At Edwards' request, Lark entered into an agreement with Owen and Ward for them to act as compensated sureties on the loan in the amount of $200,000 each. If Edwards releases Ward without Owen's or Lark's consent, and Lark later defaults, which of the following statements is correct?

a. Lark will be released for 50% of the loan balance.
b. Owen will be liable for the entire loan balance.
c. Owen will be liable for 50% of the loan balance.
d. Edwards' release of Ward will have no effect on Lark's and Owen's liability to Edwards.

**M91#27.** Lane promised to lend Turner $240,000 if Turner obtained sureties to secure the loan. Turner agreed with Rivers, Clark, and Zane for them to act as sureties on the loan from Lane. The agreement between Turner and the sureties provided that compensation be paid to each of the sureties. It further indicated that the maximum liability of each surety would be as follows: Rivers $240,000, Clark $80,000, and Zane $160,000. Lane accepted the commitments of the sureties and made the loan to Turner. After paying ten installments totaling $100,000, Turner defaulted. Clark's debts, including the surety obligation to Lane on the Turner loan, were discharged in bankruptcy. Later, Rivers properly paid the entire outstanding debt of $140,000. What amount may Rivers recover from Zane?

a. $0
b. $56,000
c. $70,000
d. $84,000

**N90#26.** Sorus and Ace have agreed, in writing, to act as guarantors of collection on a debt owed by Pepper to Towns, Inc. The debt is evidenced by a promissory note. If Pepper defaults, Towns will be entitled to recover from Sorus and Ace unless

a. Sorus and Ace are in the process of exercising their rights against Pepper.
b. Sorus and Ace prove that Pepper was insolvent at the time the note was signed.
c. Pepper dies before the note is due.
d. Towns has not attempted to enforce the promissory note against Pepper.

**N89#20.** Burns borrowed $240,000 from Dollar Bank as additional working capital for his business. Dollar required that the loan be collateralized to the extent of 20%, and that an acceptable surety for the entire amount be obtained. Surety Co. agreed to act as surety on the loan and Burns pledged $48,000 of negotiable bearer bonds. Burns defaulted. Which of the following statements is correct?

a. Dollar must first liquidate the collateral before it can proceed against Surety.
b. Surety is liable in full immediately upon default by Burns, but will be entitled to the collateral upon satisfaction of the debt.
c. Dollar must first proceed against Burns and obtain a judgment before it can proceed against the collateral.
d. Surety may proceed against Burns for the full amount of the loan even if Surety settles with Dollar for a lower amount.
N89#21. If a debtor defaults and the debtor's surety satisfies the obligation, the surety acquires the right of
   a. Subrogation.
   b. Primary lien.
   c. Indemnification.
   d. Satisfaction.

N88#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.

N88#21. Ott and Bane agreed to act as co-sureties on an $80,000 loan that Cread Bank made to Dash. Ott and Bane are each liable for the entire $80,000 loan. Subsequently, Cread released Ott from liability without Bane's consent and without reserving its rights against Bane. If Dash subsequently defaults, Cread will be entitled to collect a maximum of
   a. $0 from Bane.
   b. $0 from Dash.
   c. $40,000 from Bane.
   d. $40,000 from Dash.

N88#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.

N87
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.

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).

B. Bankruptcy

M91#29. Unger owes a total of $50,000 to eight unsecured creditors and one fully secured creditor. Quincy is one of the unsecured creditors and is owed $6,000. Quincy has filed a petition against Unger under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. Unger has been unable to pay debts as they become due. Unger's liabilities exceed Unger's
assets. Unger has filed papers opposing the bankruptcy petition. Which of the following statements regarding Quincy’s petition is correct?

a. It will be dismissed because the secured creditor failed to join in the filing of the petition.
b. It will be dismissed because three unsecured creditors must join in the filing of the petition.
c. It will be granted because Unger’s liabilities exceed Unger’s assets.
d. It will be granted because Unger is unable to pay Unger’s debts as they become due.

M91 #30. A voluntary petition filed under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code

a. Is not available to a corporation unless it has previously filed a petition under the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code.
b. Automatically stays collection actions against the debtor except by secured creditors.
c. Will be dismissed unless the debtor has 12 or more unsecured creditors whose claims total at least $5,000.
d. Does not require the debtor to show that the debtor’s liabilities exceed the fair market value of assets.

M91 #31. In general, which of the following debts will be discharged under the voluntary liquidation provisions of Chapter 7 of the Federal Bankruptcy Code?

a. A debt due to the negligence of the debtor arising before filing the bankruptcy petition.
b. Alimony payments owed the debtor’s spouse under a separation agreement entered into two years before the filing of the bankruptcy petition.
c. A debt incurred more than 90 days before the filing of the bankruptcy petition and not disclosed in the petition.
d. Income taxes due within two years before the filing of the bankruptcy petition.

d. Stark’s security interest constitutes a voidable preference because the financing statement was filed within 90 days before the bankruptcy proceeding was filed.
d. Stark is a secured creditor and can assert a claim to the circuit tester that will be superior to the claims of Peters’ other creditors.

M91
Items 33 and 34 are based on the following:

On May 1, 1991, two months after becoming insolvent, Quick Corp., an appliance wholesaler, filed a voluntary petition for bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code. On October 15, 1990, Quick’s board of directors had authorized and paid Erly $50,000 to repay Erly’s April 1, 1990, loan to the corporation. Erly is a sibling of Quick’s president. On March 15, 1991, Quick paid Kray $100,000 for inventory delivered that day.

33. Which of the following is not relevant in determining whether the repayment of Erly’s loan is a voidable preferential transfer?

a. Erly is an insider.
b. Quick’s payment to Erly was made on account of an antecedent debt.
c. Quick’s solvency when the loan was made by Erly.
d. Quick’s payment to Erly was made within one year of the filing of the bankruptcy petition.

34. Quick’s payment to Kray would

a. Not be voidable, because it was a contemporaneous exchange.
b. Not be voidable, unless Kray knew about Quick’s insolvency.
c. Be voidable, because it was made within 90 days of the bankruptcy filing.
d. Be voidable, because it enabled Kray to receive more than it otherwise would receive from the bankruptcy estate.

M91 #35. Decal Corp. incurred substantial operating losses for the past three years. Unable to meet its current obligations, Decal filed a petition for reorganization under Chapter 11 of the Federal Bankruptcy Code. Which of the following statements is correct?

a. A creditors’ committee, if appointed, will consist of unsecured creditors.
b. The court must appoint a trustee to manage Decal’s affairs.
c. Decal may continue in business only with the approval of a trustee.
d. The creditors’ committee must select a trustee to manage Decal’s affairs.

N90 #27. On June 5, 1989, Gold rented equipment under a four-year lease. On March 8, 1990, Gold was petitioned involuntarily into bankruptcy under the Fed-
eral Bankruptcy Code’s liquidation provisions. A trustee was appointed. The fair market value of the equipment exceeds the balance of the lease payments due. The trustee
   a. May not reject the equipment lease because the fair market value of the equipment exceeds the balance of the lease payments due.
   b. May elect not to assume the equipment lease.
   c. Must assume the equipment lease because its term exceeds one year.
   d. Must assume and subsequently assign the equipment lease.

N90#28. Flax, a sole proprietor, has been petitioned involuntarily into bankruptcy under the Federal Bankruptcy Code’s liquidation provisions. Simon & Co., CPAs, has been appointed trustee of the bankruptcy estate. If Simon also wishes to act as the tax return preparer for the estate, which of the following statements is correct?
   a. Simon is prohibited from serving as both trustee and preparer under any circumstances because serving in that dual capacity would be a conflict of interest.
   b. Although Simon may serve as both trustee and preparer, it is entitled to receive a fee only for the services rendered as a preparer.
   c. Simon may employ itself to prepare tax returns if authorized by the court and may receive a separate fee for services rendered in each capacity.
   d. Although Simon may serve as both trustee and preparer, its fee for services rendered in each capacity will be determined solely by the size of the estate.

N90#29. A contested involuntary petition in bankruptcy will be dismissed if the debtor
   a. Owes unsecured obligations exceeding $5,000 to less than three creditors.
   b. Had all its property taken to enforce a lien within 120 days of filing.
   c. Is failing to pay undisputed debts as they become due.
   d. Is an individual engaged in the business of farming.

N90#30. Larson, an unemployed carpenter, filed for voluntary bankruptcy on August 14, 1990. Larson’s liabilities are listed below.

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit card charges due May 2, 1989</td>
<td>$3,000</td>
</tr>
<tr>
<td>Bank loan incurred June 1990</td>
<td>$5,000</td>
</tr>
<tr>
<td>Medical expenses incurred June 1983</td>
<td>$7,000</td>
</tr>
<tr>
<td>Alimony due during 1988</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Under the provisions of Chapter 7 of the Federal Bankruptcy Code, Larson’s discharge will not apply to the unpaid
   a. Credit card charges.
   b. Bank loan.
   c. Medical expenses.
   d. Alimony.

N90#31. In a voluntary bankruptcy proceeding under Chapter 7 of the Federal Bankruptcy Code, which of the following claims incurred within 180 days prior to filing will be paid first?
   a. Unsecured federal taxes.
   b. Utility bills up to $1,000.
   c. Voluntary contributions to employee benefit plans.
   d. Employee vacation and sick pay up to $2,000 per employee.

N90#32. Chapter 7 of the Federal Bankruptcy Code will deny a debtor a discharge when the debtor
   a.Made a preferential transfer to a creditor.
   b. Accidentally destroyed information relevant to the bankruptcy proceeding.
   c. Obtained a Chapter 7 discharge 10 years previously.
   d. Is a corporation or a partnership.

N90#33. A claim will not be discharged in a bankruptcy proceeding if it
   a. Is brought by a secured creditor and remains unsatisfied after receipt of the proceeds from the disposition of the collateral.
   b. Is for unintentional torts that resulted in bodily injury to the claimant.
   c. Arises from an extension of credit based upon false representations.
   d. Arises out of the breach of a contract by the debtor.

N90#34. On May 24, Knurl, an appliance dealer, filed for bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code. A trustee was appointed and an order for relief was entered. Knurl’s nonexempt property was converted to cash, which is available to satisfy the following claims and expenses:

<table>
<thead>
<tr>
<th>Claim</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim by Card Corp. (one of Knurl’s suppliers) for toasters ordered on May 11, and delivered on credit to Knurl on May 15.</td>
<td>$50,000</td>
</tr>
<tr>
<td>Fee earned by the bankruptcy trustee.</td>
<td>$12,000</td>
</tr>
<tr>
<td>Claim by Hill Co. for the delivery of televisions to Knurl on credit. The televisions were delivered on April 9, and a financing statement was properly filed on April 10. These televisions were sold by the trustee with Hill’s consent for $7,000, their fair market value.</td>
<td>$7,000</td>
</tr>
<tr>
<td>Fees earned by the attorneys for the bankruptcy estate.</td>
<td>$8,000</td>
</tr>
</tbody>
</table>

The cash available for distribution includes the proceeds from the sale of the televisions. What amount will be distributed to Card if the cash available for distribution is $50,000?
   a. $23,000
   b. $30,000
   c. $31,000
   d. $43,000
**Selected Questions**

**N80#35.** A bankrupt who filed voluntarily and received a discharge in bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code  
   a. May obtain another voluntary discharge in bankruptcy under Chapter 7 after five years have elapsed from the date of the prior filing.  
   b. Will receive a discharge of any and all debts owed.  
   c. Is precluded from owning or operating a similar business for two years.  
   d. Must surrender to distribution to the creditors any amount received as an inheritance if received within 180 days after filing the petition.

**N89#22.** Rolf, an individual, filed a voluntary petition in bankruptcy. A general discharge in bankruptcy will be denied if Rolf  
   a. Negligently made preferential transfers to certain creditors within 90 days of filing the petition.  
   b. Unjustifiably failed to preserve Rolf’s books and records.  
   c. Filed a fraudulent federal income tax return two years prior to filing the petition.  
   d. Obtained a loan by using financial statements that Rolf knew were false.

**N89#23.** The filing of an involuntary petition in bankruptcy  
   a. Allows creditors to continue their collection actions against the debtor while the bankruptcy action is pending.  
   b. Terminates liens associated with exempt property.  
   c. Stops the enforcement of a judgment lien against property in the bankruptcy estate.  
   d. Terminates all security interests in property in the bankruptcy estate.

**N89#24.** Which of the following statements is correct concerning the voluntary filing of a petition in bankruptcy?  
   a. The debtor must be insolvent.  
   b. The petition may be filed by husband and wife jointly.  
   c. If the debtor has 12 or more creditors, the debtor’s unsecured claims must total at least $5,000.  
   d. If the debtor has fewer than 12 creditors, the debtor’s unsecured claims must total at least $5,000.

**N89#25.** Filing a valid petition in bankruptcy acts as an automatic stay of actions to

<table>
<thead>
<tr>
<th>Garnish the debtor's wages</th>
<th>Collect alimony from the debtor</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>

**N88#26.** Eagle Corp. is a general creditor of Dodd. Dodd filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Eagle wishes to have the bankruptcy court either deny Dodd a general discharge or not have its debt discharged. The discharge will be granted and it will include Eagle’s debt even if  
   a. Dodd filed for and received a previous discharge in bankruptcy under the liquidation provisions within five years of the filing of the present petition.  
   b. Eagle’s debt is unscheduled.  
   c. Eagle was a secured creditor not fully satisfied from the proceeds obtained on disposition of the collateral.  
   d. Dodd unjustifiably failed to preserve the records from which Dodd’s financial condition might be ascertained.

**N89#27.** Which of the following assets would be included in a debtor’s bankruptcy estate in a liquidation proceeding?  
   a. Proceeds from a life insurance policy received 90 days after the petition was filed.  
   b. An inheritance received 270 days after the petition was filed.  
   c. Property from a divorce settlement received 365 days after the petition was filed.  
   d. Wages earned by the debtor after the petition was filed.

**N89#28.** Which of the following unsecured debts of $500 each would have the highest relative priority in the distribution of a bankruptcy estate in a liquidation proceeding?  
   a. Tax claims of state and municipal governmental units.  
   b. Liabilities to employee benefit plans arising from services rendered during the month preceding the filing of the petition.  
   c. Claims owed to customers who gave deposits for the purchase of undelivered consumer goods.  
   d. Wages earned by employees during the month preceding the filing of the petition.

**N89#29.** As an alternative to bankruptcy liquidation, a business may reorganize under Chapter 11 of the Bankruptcy Code. Such a reorganization  
   a. Requires the appointment of a trustee to administer the debtor organization.  
   b. May be commenced by filing either a voluntary or involuntary petition.  
   c. Never requires the appointment of a creditors’ committee.  
   d. May not be confirmed unless all creditors accept the plan.

**N88.** Items 23 and 24 are based on the following:

On July 15, 1988, White, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquida-
tion 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:

Unsecured claim for 1986 state income tax $10,000
Fee owed to Best & Co., CPAs, for services rendered from April 1, 1988, through June 30, 1988 $6,000
Unsecured claim by Stieb for wages earned as an employee of White during March, 1988 $3,000

There are no other claims.

23. What is the maximum amount that will be distributed for the payment of the 1986 state income tax?
   a. $4,000
   b. $5,000
   c. $7,000
   d. $10,000

24. What is the maximum amount that will be distributed to Stieb?
   a. $0
   b. $1,000
   c. $2,000
   d. $3,000

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>

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.

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.

30. 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:
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#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 voluntarily 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.

V. Government Regulation of Business

A. Regulation of Employment

M91#36. Social security benefits may include all of the following except
   a. Payments to divorced spouses.
   b. Payments to disabled children.
   c. Medicare payments.
   d. Medicaid payments.

M91#37. An employer having an experience unemployment tax rate of 3.2% in a state having a standard unemployment tax rate of 5.4% may take a credit against a 6.2% federal unemployment tax rate of
   a. 3.0%
   b. 3.2%
   c. 5.4%
   d. 6.2%

M91#38. The primary purpose for enacting Workers' Compensation statutes was to
   a. Eliminate all employer-employee negligence lawsuits.
   b. Enable employees to recover for injuries regardless of negligence.
   c. Prevent employee negligence suits against third parties.
   d. Allow employees to recover additional compensation for employer negligence.

M90#36. Under the Federal Insurance Contributions Act (FICA), all of the following are considered wages except
   a. Contingent fees.
   b. Reimbursed travel expenses.
   c. Bonuses.
   d. Commissions.
**Selected Questions**

**N90#37.** The Federal Unemployment Tax Act (FUTA)

- Requires both the employer and employee to pay FUTA taxes, although the amounts to be paid by each are different.
- Does not apply to businesses with fewer than 35 employees.
- Does not apply to employers that conduct business only in one state and employ only residents of that state.
- Allows the employer to take a credit against the FUTA tax if contributions are made to a state unemployment fund.

**N90#38.** If an employee is injured, full workers’ compensation benefits are not payable if the employee

- Was injured because of failing to abide by written safety procedures.
- Was injured because of the acts of fellow employees.
- Intentionally caused self-inflicted injury.
- Brought a civil suit against a third party who caused the injury.

**N90#26.** Tower drives a truck for Musgrove Produce, Inc. The truck is owned by Musgrove. Tower is paid on the basis of a formula that takes into consideration the length of the trip, cargo, and fuel consumed. Tower is responsible for repairing or replacing all flat tires. Musgrove is responsible for all other truck maintenance. Tower drives only for Musgrove. If Tower is a common law employee and not an independent contractor, which of the following statements is correct?

- All social security retirement benefits are fully includable in the determination of Tower’s federal taxable income if certain gross income limitations are exceeded.
- Musgrove remains primarily liable for Tower’s share of FICA taxes if it fails to withhold and pay the taxes on Tower’s wages.
- Musgrove would not have to withhold FICA taxes if Tower elected to make FICA contributions as a self-employed person.
- Bonuses or vacation pay that are paid to Tower by Musgrove are not subject to FICA taxes because they are not regarded as regular compensation.

**N90#39.** Which of the following statements is correct regarding social security taxes?

- An individual who received net earnings from self-employment of $40,000 and wages of $40,000 in 1988 will be subject to social security taxes on $80,000.
- Part of an employee’s social security tax contribution qualifies for federal income tax purposes as a deduction from the employee’s gross income.
- A self-employed person is subject to social security taxes based on that person’s gross earnings from self-employment.
- An employer who fails to withhold and pay the employee’s portion of social security taxes remains primarily liable for the employee’s share.

**N90#31.** Which of the following statements is not correct concerning federal unemployment insurance?

- Federal law provides general guidelines, standards, and requirements for the program.
- The states administer the benefit payments under the program.
- The program is funded by taxes imposed on employers and employees.
- The federal unemployment tax is calculated as a fixed percentage of each covered employee’s salary up to a stated maximum.

**N90#32.** An employee will generally be precluded from collecting full workers’ compensation benefits when the injury is caused by

<table>
<thead>
<tr>
<th>Noncompliance with the employer's rules</th>
<th>An intentional, self-inflicted action</th>
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<tr>
<td>a. No</td>
<td>No</td>
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<td>b. Yes</td>
<td>Yes</td>
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<td>c. No</td>
<td>Yes</td>
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<tr>
<td>d. Yes</td>
<td>No</td>
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</table>

**N90#36.** The Federal Unemployment Tax Act

- Imposes a tax on all employers doing business in the U.S.
- Requires contributions to be made by the employer and employee equally.
- Allows an employer to take a credit against the federal unemployment tax if contributions are made to a state unemployment fund.
- Permits an employee to receive unemployment benefits that are limited to the contributions made to that employee’s account.

**N90#37.** Under the Federal Insurance Contributions Act (FICA) and the Social Security Act (SSA)

- Persons who are self-employed are not required to make FICA contributions.
- Employees who participate in private retirement plans are not required to make FICA contributions.
Business Law

c. Death benefits are payable to an employee's survivors only if the employee dies before reaching the age of retirement.
d. The receipt of earned income by a person who is also receiving social security retirement benefits may result in a reduction of such benefits.

M88#38. Which one of the following statements concerning workers' compensation laws is generally correct?

a. Workers' compensation laws are very narrowly construed against employees.
b. The amount of damages recoverable is based on comparative negligence.
c. Employers are strictly liable without regard to whether or not they are at fault.
d. Workers' compensation benefits are not available if the employee is grossly negligent.

M88#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.

c. Death benefits are payable to an employee's survivors only if the employee dies before reaching the age of retirement.
d. The receipt of earned income by a person who is also receiving social security retirement benefits may result in a reduction of such benefits.

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d. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of the individual's adjusted gross income for federal income tax purposes.

M88#43. Which of the following statements is correct with respect to social security taxes and benefits?

a. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of taxable income.
b. Benefits are available to a qualifying individual or that individual's family only upon retirement or disability.
c. An employer that erroneously underwitholds and underpays an employee's share of social security taxes will be liable for the unpaid balance of the employee's share.
d. An individual whose private pension benefits exceed certain maximum limitations will have social security retirement benefits reduced.

M88#44. Bing was employed as a taxi driver by Speedy, Inc. While acting in the scope and course of his employment with Speedy, Bing collided with a van driven by Hart. Hart was an independent contractor making a delivery for Troy Corp. The collision was caused solely by Bing's negligence. As a result of the collision, both Bing and Hart suffered permanent injuries. Speedy and Troy were both in compliance with the state's workers' compensation statute. If Hart commences an action against Bing and Speedy for negligence, which of the following statements is correct?

a. Hart is entitled to recover damages from Bing or Speedy.
b. Bing will either be denied workers' compensation benefits or have his benefits reduced because of his negligence.
c. Hart's action for negligence will be dismissed because Hart is an independent contractor.
d. Hart is entitled to recover damages from Speedy's workers' compensation carrier to the extent no duplicate payment has been received by Hart.

M88#45. In general, which of the following statements is correct with respect to unemployment compensation?

a. An employee who is unable to work because of a disability is entitled to unemployment compensation.
b. An individual who has been discharged from employment because of work-connected misconduct is ineligible for unemployment compensation.
c. The maximum period during which unemployment compensation may be collected is uniform throughout the United States.
d. The maximum amount of weekly unemployment compensation payments made by a state is determined by federal law.

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
Selected Questions

M97#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.

M97#38. 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.

M97#37. The social security tax base is calculated on
   b. A self-employed person's gross income from self-employment.
   c. An employee's gross wages less the deduction permitted for contributions to an individual retirement account.
   d. An employee's taxable income.

B. Federal Securities Acts

M91#39. Bird Corp. made a $500,000 exempt common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. This made the shares restricted securities. As the issuer of restricted securities, Bird must
   a. Make a reasonable effort to determine that purchasers are buying for themselves and not for others.
   b. Publicly advertise that the shares are not registered.
   c. Provide information to all purchasers as to how they can register their shares so that resale will be permitted.
   d. Apply to the SEC for contingent exemptions so that purchasers may resell their shares as exempt.

M91#40. Universal Corp. intends to sell its common stock to the public in an interstate offering that will be registered under the Securities Act of 1933. Under the Act,
   a. Universal can make offers to sell its stock before filing a registration statement, provided that it does not actually issue stock certificates until after the registration is effective.
   b. Universal's registration statement becomes effective at the time it is filed, assuming the SEC does not object within 20 days thereafter.
   c. A prospectus must be delivered to each purchaser of Universal's common stock unless the purchaser qualifies as an accredited investor.
   d. Universal's filing of a registration statement with the SEC does not automatically result in compliance with the "blue-sky" laws of the states in which the offering will be made.

M91#41. The registration of a security under the Securities Act of 1933 provides an investor with
   a. A guarantee by the SEC that the facts contained in the registration statement are accurate.
   b. An assurance against loss resulting from purchasing the security.
   c. Information on the principal purposes for which the offering's proceeds will be used.
   d. Information on the issuing corporation's trade secrets.

M91#42. Which of the following statements is correct regarding the proxy solicitation requirements of Section 14(a) of the Securities Exchange Act of 1934?
   a. A corporation does not have to file proxy revocation solicitations with the SEC if it is a reporting company under the Securities Exchange Act of 1934.
   b. Current unaudited financial statements must be sent to each stockholder with every proxy solicitation.
   c. A corporation must file its proxy statements with the SEC if it is a reporting company under the Securities Exchange Act of 1934.
   d. In a proxy solicitation by management relating to election of officers, all stockholder proposals must be included in the proxy statement.

M91#44. The antifraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934
   a. Apply only if the securities involved were registered under either the Securities Act of 1933 or the Securities Exchange Act of 1934.
   b. Require that the plaintiff show negligence on the part of the defendant in misstating facts.
   c. Require that the wrongful act must be accomplished through the mail, any other use of interstate commerce, or through a national securities exchange.
   d. Apply only if the defendant acted with intent to defraud.
M91#45. Which of the following securities is exempt from the registration requirements of the Securities Act of 1933?
   a. Common stock with no par value.
   b. Warrants to purchase preferred stock.
   c. Bonds issued by a charitable foundation.
   d. Convertible debentures issued by a corporation.

M91#46. Winslow, Inc. intends to make a $450,000 common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. Winslow
   a. May make the offering through a general advertising.
   b. Must provide all investors with a prospectus.
   c. May sell the stock to an unlimited number of investors.
   d. Must offer the stock for a period of 24 months.

M90#39. The registration requirements of the Securities Act of 1933 are intended to provide information to the SEC to enable it to
   a. Evaluate the financial merits of the securities being offered.
   b. Ensure that investors are provided with adequate information on which to base investment decisions.
   c. Prevent public offerings of securities when management fraud or unethical conduct is suspected.
   d. Assure investors of the accuracy of the facts presented in the financial statements.

M90#40. The registration provisions of the Securities Exchange Act of 1934 require disclosure of all of the following information except the
   a. Names of owners of at least five (5) percent of any class of nonexempt equity security.
   b. Bonus and profit-sharing arrangements.
   c. Financial structure and nature of the business.
   d. Names of officers and directors.

M90#41. Corporations that are exempt from registration under the Securities Exchange Act of 1934 are subject to the Act's
   a. Provisions dealing with the filing of annual reports.
   c. Antifraud provisions.
   d. Proxy solicitation provisions.

M90#42. The Securities Act of 1933 provides an exemption from registration for

<table>
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<tr>
<th>Bonds issued by a municipality for governmental purposes</th>
<th>Securities issued by a not-for-profit charitable organization</th>
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<tr>
<td>a. No</td>
<td>No</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. Yes</td>
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M90#43. Imperial Corp. is offering $450,000 of its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, Imperial is required to
   a. Provide full financial information to all non-accredited purchasers.
   b. Make the offering through general solicitation.
   c. Register the offering under the provisions of the Securities Exchange Act of 1934.
   d. Notify the SEC within 15 days after the first sale of the securities.

M90#44. Hamilton Corp. is making a $4,500,000 securities offering under Rule 505 of Regulation D of the Securities Act of 1933. Under this regulation, Hamilton is
   a. Required to provide full financial information to accredited investors only.
   b. Allowed to make the offering through a general solicitation.
   c. Limited to selling to no more than 35 non-accredited investors.
   d. Allowed to sell to an unlimited number of investors both accredited and nonaccredited.

M90#45. A $10,000,000 offering of corporate stock intended to be made pursuant to the provisions of Rule 506 of Regulation D of the Securities Act of 1933 would not be exempt under Rule 506 if
   a. The offering was made through a general solicitation or advertising.
   b. Some of the investors are nonaccredited.
   c. There are more than 35 accredited investors.
   d. The SEC was notified 14 days after the first sale of the securities.

M90#28. Which of the following is least likely to be considered a security under the Securities Act of 1933?
   a. General partnership interests.
   b. Limited partnership interests.
   c. Stock options.
   d. Warrants.

M90#29. Under the Securities Act of 1933, the registration of an interstate securities offering is
   a. Required only in transactions involving more than $500,000.
Selected Questions

b. Mandatory, unless the cost to the issuer is prohibitive.

c. Required, unless there is an applicable exemption.

d. Intended to prevent the marketing of securities which pose serious financial risks.

**M90#30.** Dice, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security Dice issued is voting common stock. With regard to Dice’s proxy solicitation requirements, which of the following statements is correct?

a. Dice must file its proxy statements with the SEC even though it has only one class of stock outstanding.

b. Dice’s current unaudited financial statements must be sent to each shareholder with every proxy solicitation.

c. Shareholder proposals need not be included in the proxy statements unless consented to by a majority of Dice’s board of directors.

d. Dice need not provide any particular information to its shareholders unless Dice is soliciting proxies from them.

**M90#31.** Under the Securities Exchange Act of 1934, which of the following individuals would not be subject to the insider reporting provisions?

a. An owner of ten percent of a corporation’s stock.

b. An owner of five percent of a corporation’s voting stock.

c. The vice-president of marketing.

d. A member of the board of directors.

**M90#32.** Which of the following are exempt from the registration requirements of the Securities Act of 1933?

a. Bankers’ acceptances with maturities at the time of issue ranging from one to two years.

b. Participation interests in money market funds that consist wholly of short-term commercial paper.

c. Corporate stock offered and sold only to residents of the state in which the issuer was incorporated and is doing all of its business.

d. All industrial development bonds issued by municipalities.

**M90#33.** Pate Corp. is offering $3 million of its securities solely to accredited investors. Under Regulation D of the Securities Act of 1933, Pate is

a. Not required to provide any specified information to the accredited investors.

b. Permitted to make a general solicitation.

c. Not allowed to sell to investors using purchaser representatives.

d. Required to provide accredited investors with audited financial statements for the three most recent fiscal years.

**M90#34.** Regulation D of the Securities Act of 1933

a. Is limited to offers and sales of common stock that do not exceed $1.5 million.

b. Is exclusively available to small business corporations as defined by Regulation D.

c. Permits an exempt offering to be sold to both accredited and nonaccredited investors.

d. Restricts the number of purchasers of an offering to 35.

**M90#37.** Zack Limited Partnership intends to sell $6,000,000 of its limited partnership interests. Zack conducts all of its business activities in the state in which it was organized. Zack intends to use the offering proceeds to acquire municipal bonds. Which of the following statements is correct concerning the offering and the registration exemptions that might be available to Zack under the Securities Act of 1933?

a. The offering is exempt from registration because of the intended use of the offering proceeds.

b. Under Rule 147 (regarding intrastate offerings), Zack may make up to five offers to nonresidents without jeopardizing the Rule 147 exemption.

**M90#33.** One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed pursuant to the Securities Act of 1933 is that the

a. Plaintiff suffered a loss.

b. Plaintiff gave value for the security.

c. Issuer and plaintiff were in privity of contract with each other.

d. Issuer failed to exercise due care in connection with the sale of the securities.

**M90#34.** To be successful in a civil action under Section 11 of the Securities Act of 1933 concerning liability for a misleading registration statement, the plaintiff must prove

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<tr>
<th>Defendant’s intent to deceive</th>
<th>Plaintiff’s reliance on the registration statement</th>
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<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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N89#35. An issuer making an offering under the provisions of Regulation A of the Securities Act of 1933 must file a(an)
   a. Prospectus.
   b. Offering statement.
   c. Shelf registration.
   d. Proxy.

N89#36. Under the provisions of the Securities Exchange Act of 1934, a corporation whose common stock is listed on a national stock exchange
   a. Is prohibited from making private placement offerings.
   b. Must submit Form 10-K to the SEC except in those years in which the corporation has made a public offering.
   c. Must distribute copies of Form 10-K to its shareholders.
   d. Is subject to having the registration of its securities suspended or revoked.

N89#37. Rule 504 of Regulation D of the Securities Act of 1933 provides issuers with an exemption from registration for certain small issues. Which of the following statements is correct?
   a. The rule allows sales to an unlimited number of investors.
   b. The rule requires certain financial information to be furnished to the investors.
   c. The issuer must offer the securities through general public advertising.
   d. The issuer is not required to file anything with the SEC.

N89#38. Securities available under a private placement made pursuant to Regulation D of the Securities Act of 1933
   a. Cannot be subject to the payment of commissions.
   b. Must be sold to accredited institutional investors.
   c. Must be sold to fewer than 20 non-accredited investors.
   d. Cannot be the subject of an immediate unregistered reoffering to the public.

N89#39. Which of the following types of securities are generally exempt from registration under the Securities Act of 1933?

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<tr>
<th>Securities of nonprofit charitable organizations</th>
<th>Securities of savings and loan associations</th>
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<tr>
<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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N89#39. With regard to an offering of common stock requiring registration under the Securities Act of 1933,
   a. The SEC will attempt to pass on the investment value of the common stock before approving the offering.
   b. The registration statement is automatically effective when filed with the SEC.
   c. The issuer may make sales 10 days after filing the registration statement.
   d. The issuer would act unlawfully if it were to sell the common stock without providing the investor with a prospectus.

N89#40. Acme Corp. intends to make a public offering in several states of 250,000 shares of its common stock. Under the Securities Act of 1933,
   a. Acme must sell the common stock through licensed securities dealers.
   b. Acme must, in all events, file a registration statement with the SEC because the offering will be made in several states.
   c. Acme's use of any prospectus delivered to an unsophisticated investor must be accompanied by a simplified explanation of the offering.
   d. Acme may make an oral offer to sell the common stock to a prospective investor after a registration statement has been filed but before it becomes effective.

N89#41. Pace Corp. previously issued 300,000 shares of its common stock. The shares are now actively traded on a national securities exchange. The original offering was exempt from registration under the Securities Act of 1933. Pace has $2,500,000 in assets and 425 shareholders. With regard to the Securities Exchange Act of 1934, Pace is
   a. Required to file a registration statement because its assets exceed $2,000,000 in value.
   b. Required to file a registration statement even though it has fewer than 500 shareholders.
   c. Not required to file a registration statement because the original offering of its stock was exempt from registration.
   d. Not required to file a registration statement unless insiders own at least 5% of its outstanding shares of stock.

N89#42. Rice, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which one of the following statements is correct?
   a. Any person who owns more than 5% of Rice's common stock must file a report with the SEC.
   b. Rice need not file its proxy statements with the SEC because it has only one class of stock outstanding.
Selected Questions

c. It is unnecessary for the required annual report (Form 10-K) to include audited financial statements.
d. Because Rice is a reporting company, it is not required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.

M89#43. Which of the following securities is exempt from registration under the Securities Act of 1933?
   a. A class of shares of stock given in exchange for another class by the issuer to its existing shareholders without payment of a commission.
b. Limited partnership interests sold for the purpose of acquiring funds to invest in bonds issued by the United States.
c. Corporate debentures that were previously subject to an effective registration statement, provided they are convertible into shares of common stock.
d. Shares of common stock, provided their par value is less than $1.00 and they are nonvoting.

M89

Items 44 and 45 are based on the following:

Maco Limited Partnership intends to sell $6,000,000 of its limited partnership interests. The state in which Maco was organized is also the state in which it carries on all of its business activities.

44. If Maco intends to offer the limited partnership interests in reliance on Rule 147, the intrastate registration exception under the Securities Act of 1933, which one of the following statements is correct?
   a. Maco may make up to five offers to nonresidents without the offering being ineligible for the Rule 147 exemption.
b. The offering is not exempt under Rule 147 because it exceeds $5,000,000.
c. Under Rule 147, certain restrictions apply to resales of the limited partnership interests by purchasers.
d. Rule 147 limits to 100 the number of purchasers of the limited partnership interests.

c. Maco may make an unlimited number of offers to sell the limited partnership interests.
d. No more than 35 purchasers may acquire the limited partnership interests.

M88#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.

M88#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.

M88#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.

M88#34. Which of the following is a security that is exempt from the registration requirements of the Securities Act of 1933?
   a. Convertible, subordinated debentures issued by a manufacturing company.
b. Warrants to purchase preferred stock.
c. Bonds issued by a charitable foundation.
d. Common stock with a par value of less than $1.00.
M88#36. The principal purpose of the registration requirements of the Securities Act of 1933 is to
a. Prevent public offerings of securities in which management fraud or unethical conduct is suspected.
b. Provide the SEC with the information necessary to determine the accuracy of the facts presented in the financial statements.
c. Assure that investors have adequate information upon which to base investment decisions.
d. Provide the SEC with the information necessary to evaluate the financial merits of the securities being offered.

M88#37. Unless an exemption applies to an offering of securities, the Securities Act of 1933 requires preparation and filing of a

<table>
<thead>
<tr>
<th>Registration</th>
<th>Prospectus</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>

M88#38. Which of the following statements is correct with respect to the Securities Exchange Act of 1934?

a. Issuers whose securities are registered under the Act are required to comply with its reporting requirements.
b. The Act applies only to issuers whose securities are traded on a national securities exchange.
c. The Act subjects all issuers of securities to its registration requirements if the issuer has more than $2.5 million of assets or more than 250 shareholders.
d. The antifraud provisions of the Act do not apply to issuers of securities that are exempt from the Act’s registration requirements.

M88#39. In order to raise $375,000, Penn Corp. is offering its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, the offering
a. Must be sold to accredited investors.
b. Can not be sold to more than 35 non-accredited investors.
c. Can be sold to an unlimited number of accredited and non-accredited investors.
d. Will not subject the issuer to the antifraud provisions of the Securities Act of 1933.

M88#40. If securities are registered under the Securities Exchange Act of 1934, which of the following disclosure provisions apply?

Notice of sales of the registered securities by the corporation’s officers must be filed with the SEC
a. No 

Proxy material for the registered securities must be filed with the SEC
a. No 

M88#42. In general, the Securities Act of 1933 provides for an exemption from registration for

A stock dividend issued to existing shareholders
a. No 

Bonds issued by a municipality for governmental purposes
a. No 

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#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.
Selected Questions

N87#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.

N87#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.

N87#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.

N87#40. On May 1, Apel purchased 7% of Stork Corp.'s preferred stock which was traded on a national securities exchange. After the purchase Apel owned 9% of the outstanding preferred stock. Stork is registered under the Securities Exchange Act of 1934. With respect to the purchase, Apel
   a. Is not required to file any report or information with the SEC since Apel owns less than 10% of the preferred stock.
   b. Is 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.

N87#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.

N87#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.

N87#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.

N87#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.
A. Commercial Paper

**N90#46.** Union Co. possesses the following instrument:

<table>
<thead>
<tr>
<th>Holt, MT</th>
<th>$4,000</th>
<th>April 15, 1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fifty days after date, or sooner, the undersigned promises to pay to the order of</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Union Co.</strong></td>
<td><strong>Four Thousand Dollars</strong></td>
<td></td>
</tr>
<tr>
<td>at</td>
<td><strong>Salem Bank, Holt, MT</strong></td>
<td></td>
</tr>
<tr>
<td>Ten percent interest per annum.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>This instrument is secured by the maker's business inventory.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**EASY, INC.**
**BY:** Thomas Foy
**Thomas Foy, President**

Assuming all other requirements of negotiability are satisfied, this instrument is

a. Not negotiable because of a lack of a definite time for payment.
b. Not negotiable because the amount due is unspecified.
c. Negotiable because it is secured by the maker's inventory.
d. Negotiable because it is payable in a sum certain in money.

**N90#47.** A $5,000 promissory note payable to the order of Neptune is discounted to Bane by blank endorsement for $4,000. King steals the note from Bane and sells it to Ott who promises to pay King $4,500. After paying King $3,000, Ott learns that King stole the note. Ott makes no further payment to King. Ott is

a. A holder in due course to the extent of $5,000.
b. An ordinary holder to the extent of $4,500.
c. A holder in due course to the extent of $3,000.
d. An ordinary holder to the extent of $0.

**N90#48.** A maker of a note will have a valid defense against a holder in due course as a result of any of the following conditions except

a. Lack of consideration.
b. Infancy.
c. Forgery.
d. Fraud in the execution.

**N90#49.** The following note was executed by Elizabeth Quinton on April 17, 1990 and delivered to Ian Wolf:

**(Face)**
April 17, 1990

On demand, the undersigned promises to pay to the order of Ian Wolf

Seven Thousand and 00/100 DOLLARS

Elizabeth Quinton
Elizabeth Quinton

**(Back)**

Ian Wolf
**Ian Wolf**
Pay: George Vernon
**Samuel Thorn**
Pay: Alan Yule
**George Vernon**
**Alan Yule**

In sequence, beginning with Wolf's receipt of the note, this note is properly characterized as what type of commercial paper?

a. Bearer, bearer, order, order, order.
b. Order, bearer, order, order, bearer.
c. Order, order, bearer, order, bearer.
d. Bearer, order, order, order, bearer.

**N90#35.** Which of the following negotiable instruments is subject to the provisions of the UCC Commercial Paper Article?

a. Installment note payable on the first day of each month.
b. Warehouse receipt.
c. Bill of lading payable to order.
d. Corporate bearer bond with a maturity date of January 1, 1999.
Selected Questions

M90#36. Below is a copy of a note Prestige Properties obtained from Tim Hart in connection with Hart’s purchase of land located in Hunter, MT. The note was given for the balance due on the purchase and was secured by a first mortgage on the land.

| $200,000.00 | November 30, 1989 |
| Hunter, MT | |

For value received, six years after date, I promise to pay to the order of Prestige Properties TWO HUNDRED THOUSAND and 00/100 DOLLARS with interest at 11% compounded annually until fully paid. This instrument arises out of the sale of land located in MT and the law of MT is to be applied to any question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed that:
1. Maker will pay the costs of collection including attorney’s fees upon default.
2. Maker may repay the amount outstanding on any anniversary date of this note.

Tim Hart

Tim Hart

This note is a
a. Nonnegotiable promissory note because it is secured by a first mortgage.
b. Negotiable promissory note.
c. Nonnegotiable promissory note because it permits prepayment and requires the maker’s payment of the costs of collection and attorney’s fees.
d. Negotable investment security under the UCC.

M90#38. Bond fraudulently induced Teal to make a note payable to Wilk, to whom Bond was indebted. Bond delivered the note to Wilk. Wilk negotiated the instrument to Monk, who purchased it with knowledge of the fraud and after it was overdue. If Wilk qualifies as a holder in due course, which of the following statements is correct?
a. Monk has the standing of a holder in due course through Wilk.
b. Teal can successfully assert the defense of fraud in the inducement against Monk.
c. Monk personally qualifies as a holder in due course.
d. Teal can successfully assert the defense of fraud in the inducement against Wilk.

M90#39. A holder in due course will take free of which of the following defenses?
a. Infancy, to the extent that it is a defense to a simple contract.
b. Discharge of the maker in bankruptcy.
c. A wrongful filling-in of the amount payable that was omitted from the instrument.
d. Duress of a nature that renders the obligation of the party a nullity.

M90#41. Fred Anchor is the holder of the following check:

| Peter Mason |
| Champaign, Illinois |
| 4/30 19 90 |

Pay to the order of Mary Nix or bearer $93.00

Ninety-Three------------------------Dollars

Second Bank 0453-0978       Peter Mason

The check is endorsed on the back as follows:

Mary Nix
Pay to John Jacobs
Mark Harris
John Jacobs
(without recourse)

Jacobs gave the check to his son as a gift, who transferred it to Anchor for $78.00. Which of the following statements is correct?
a. The unqualified endorsement of Jacobs was necessary in order to negotiate the check to his son.
b. Nix’s endorsement was required to negotiate the check to any subsequent holder.
c. Anchor does not qualify as a holder because less than full consideration was given for the check.
d. The check is bearer paper in Jacobs’ son’s hands.

M90#40. A trade acceptance is an instrument drawn by a
a. Seller obligating the seller or designee to make payment.
b. Buyer obligating the buyer or designee to make payment.
c. Seller ordering the buyer or designee to make payment.
d. Buyer ordering the seller or designee to make payment.

M90#41. For which of the following negotiable instruments is a bank not an acceptor?
a. Cashier’s check.
b. Certified check.
c. Certificate of deposit.
d. Bank acceptance.
N89#42. Which of the following is required to make an instrument negotiable?
   a. Stated date of issue.
   b. An indorsement by the payee.
   c. Stated location for payment.
   d. Payment only in legal tender.

N89#43. Blare bought a house and provided the required funds in the form of a certified check from a bank. Which of the following statements correctly describes the legal liability of Blare and the bank?
   a. The bank has accepted; therefore, Blare is without liability.
   b. The bank has not accepted; therefore, Blare has primary liability.
   c. The bank has accepted, but Blare has secondary liability.
   d. The bank has not accepted, but Blare has secondary liability.

N89#44. Silver Corp. sold 20 tons of steel to River Corp. with payment to be by River's check. The price of steel was fluctuating daily. Silver requested that the amount of River's check be left blank and Silver would fill in the current market price. River complied with Silver's request. Within two days, Silver received River's check. Although the market price of 20 tons of steel at the time Silver received River's check was $80,000, Silver filled in the check for $100,000 and negotiated it to Hatch Corp. Hatch took the check in good faith, without notice of Silver's act or any other defense, and in payment of an antecedent debt. River will
   a. Not be liable to Hatch, because the check was materially altered by Silver.
   b. Not be liable to Hatch, because Hatch failed to give value when it acquired the check from Silver.
   c. Be liable to Hatch for $100,000.
   d. Be liable to Hatch, but only for $80,000.

N89#49. Which one of the following aspects of an otherwise negotiable promissory note will render it non-negotiable?
   a. The maker is obligated to pay a sum certain to the payee but may instead deliver to the payee goods of equal value.
   b. The maker has the right to prepay the note, subject to a prepayment penalty of 10% of the amount prepaid.
   c. The maker is obligated to pay the payee's costs of collection upon default by the maker.
   d. The maker intentionally using a rubber stamp to sign the note.

M89#49. On May 30, 1989, I promise to pay Bill North, the bearer of this document, $1,800.

Joseph Peppers

Re: Auto Purchase Contract

This instrument is
   a. Non-negotiable because it is undated.
   b. Non-negotiable because it is not payable to order or bearer.
   c. Negotiable even though it makes reference to the contract out of which it arose.
   d. Negotiable because it is payable at a definite time.

M89#48. The following instrument is in the possession of Bill North:

Pay to John Jacobs

Mary Nash

John Jacobs

(without recourse)

Which one of the following statements is correct?
   a. Mix is not a holder because Jacobs' qualified indorsement makes the note non-negotiable.
   b. Mix can negotiate the note by delivery alone.
   c. The unqualified indorsement of Mix is required in order to further negotiate the note.
   d. In order for Mix to negotiate the note Mix must have given value for it.
Selected Questions

M89#51. To the extent that a holder of a negotiable promissory note is a holder in due course, the holder takes the note free from which of the following defenses?
   b. Discharge of the maker in bankruptcy.
   c. Minority of the maker where it is a defense to enforcement of a contract.
   d. Forgery of the maker's signature.

M89#52. Jim Bass is in possession of a negotiable promissory note made payable "to bearer." Bass acquired the note from Mary Frank for value. The maker of the note was Fred Jackson. The following indorsements appear on the back of the note:

\[\begin{array}{l}
\text{Sam Peters} \\
\text{Pay to Jim Bass} \\
\text{Mary Frank} \\
\text{Jim Bass (without recourse)}
\end{array}\]

Bass presented the note to Jackson, who refused to pay it because he was financially unable to do so. Which of the following statements is correct?
   a. Peters is not secondarily liable on the note because his indorsement was unnecessary for negotiation.
   b. Peters is not secondarily liable to Bass.
   c. Frank will probably not be liable to Bass unless Bass gives notice to Frank of Jackson's refusal to pay within a reasonable time.
   d. Bass would have had secondary liability to Peters and Frank if he had not qualified his indorsement.

M89#59. A trade acceptance usually
   a. Is an order to deliver goods to a named person.
   b. Provides that the drawer is also the payee.
   c. Is not regarded as commercial paper under the UCC.
   d. Must be made payable "to the order of" a named person.

M89#35. Gold is holding the following instrument:

\[\begin{array}{c}
\text{To: Sussex National Bank} \\
\text{Suffolk, N.Y.} \\
\text{October 15, 1988} \\
\text{Pay to the order of } \text{Tom Gold} \quad \$2,000.00 \\
\text{Two Thousand and xx/100 Dollars} \\
\text{on November 1, 1988} \\
\text{Lester Davis}
\end{array}\]

This instrument is a
   a. Postdated check.
   b. Draft.
   c. Promissory note.
   d. Trade acceptance.

M89#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.

M89#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.

M89#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.
**Business Law**

**N88#39.** In general, which of the following statements is correct concerning the priority among checks drawn on a particular account and presented to the drawee bank on a particular day?

a. The checks may be charged to the account in any order convenient to the bank.
b. The checks may be charged to the account in any order provided no charge creates an overdraft.
c. The checks must be charged to the account in the order in which the checks were dated.
d. The checks must be charged to the account in the order of lowest amount to highest amount to minimize the number of dishonored checks.

**N88#40.** A purchaser of a negotiable instrument would least likely be a holder in due course if, at the time of purchase, the instrument is

a. Purchased at a discount.
b. Collateral for a loan.
c. Payable to bearer on demand.
d. Overdue by three weeks.

**N88#41.** Able drew a check payable to the order of Baker. The amount was left blank because it depended on a future delivery of fuel oil to Able, and the exact price was not known at the time the check was issued. Baker estimated the amount at $400, but told Able that in no event would it be more than $600. Baker failed to deliver the fuel oil, but filled in the amount of the check for $800. Baker then negotiated the check to Cook in satisfaction of a $600 debt, with the $200 balance paid to Baker in cash. Able stopped payment and Cook is seeking to collect $800 from Able. Able’s maximum liability to Cook will be

a. $0
b. $400
c. $600
d. $800

**N88#46.** Ard is holding the following instrument:

I, Rosemary Larkin, hereby promise to pay to the bearer twenty thousand dollars ($20,000). This document is given by me as payment of the balance due on my purchase of a 1984 Winnebago mobile home from Ed Dill and is payable when I am able to obtain a bank loan.

Rosemary Larkin

This instrument is not negotiable because it

a. Refers to the contract out of which it arose.
b. Is payable to bearer rather than to a named payee.
c. Is not dated on the face of the instrument.
d. Is not payable at a definite time.

**M88#47.** Assuming each of the following is negotiable, which qualifies as a draft under the UCC Commercial Paper Article?

a. A warehouse receipt.
b. A demand promissory note.
d. A trade acceptance.

**M88#48.** The value requirement in determining whether a person is a holder in due course with respect to a check will not be satisfied by the taking of the check

a. As security for an obligation to the extent of the obligation.
b. As payment for an antecedent debt.
c. In exchange for another negotiable instrument.
d. In exchange for a promise to perform services in the future.

**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

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.
**Selected Questions**

**M87#48.** A company has in its possession the following instrument:

<table>
<thead>
<tr>
<th>$500.00</th>
<th>Dayton, Ohio</th>
<th>October 2, 1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sixty days after date I promise to pay to the order of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>Five hundred</td>
<td>Dollars</td>
</tr>
<tr>
<td>at</td>
<td>Miami, Florida</td>
<td></td>
</tr>
</tbody>
</table>

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 | Craig Burke |

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.

**M87#49.** One of the requirements necessary to qualify as a holder of a negotiable bearer check is that the transferee must:

a. Take the check in good faith.
b. Give value for the check.
c. Have possession of the check.
d. Receive the check that was originally made payable to bearer.

**M87#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.

**M88#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.

**B. Documents of Title and Investment Securities**

**M91#47.** Which of the following statements is correct concerning a common carrier that issues a bill of lading stating that the goods are to be delivered "to the order of Ajax"?

a. The carrier's lien on the goods covered by the bill of lading for storage or transportation expenses is ineffective against the bill of lading's purchaser.
b. The carrier may not, as a matter of public policy, limit its liability for the goods by the terms of the bill.
c. The carrier must deliver the goods only to Ajax or to a person who presents the bill of lading properly endorsed by Ajax.
d. The carrier would have liability only to Ajax because the bill of lading is nonnegotiable.

**M90#50.** Kent stole several negotiable warehouse receipts from Baxter Sales Co. The receipts were deliverable to Baxter's order. Kent endorsed Baxter's name and sold the warehouse receipts to United Wholesalers, a bona fide purchaser. In an action by United against Baxter,

a. United will prevail because the warehouse receipts were converted to bearer instruments by Kent's endorsement.
b. United will prevail because it took the negotiable warehouse receipts as a bona fide purchaser for value.
c. Baxter will prevail because the warehouseman must be notified before any valid negotiation of a warehouse receipt is effective.
d. Baxter will prevail because Kent cannot validly negotiate the warehouse receipts.

**M89#53.** Under the UCC, a warehouse receipt

a. Will not be negotiable if it contains a contractual limitation on the warehouseman's liability.
b. May qualify as both a negotiable warehouse receipt and negotiable commercial paper if the instrument is payable either in cash or by the delivery of goods.
c. May be issued only by a bonded and licensed warehouseman.
d. Is negotiable if by its terms the goods are to be delivered to bearer or the order of a named person.

**M88#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.
The procedure necessary to negotiate a document of title depends principally on whether the document is
a. An order document or a bearer document.
b. Issued by a bailee or a consignee.
c. A receipt for goods stored or goods already shipped.
d. A bill of lading or a warehouse receipt.

Bond Corp. issued a negotiable warehouse receipt to Grey for goods stored in Bond's warehouse. Grey's goods were lost due to Bond's failure to exercise such care as a reasonably careful person would under like circumstances. The state in which this transaction occurred follows the UCC rule with respect to a warehouseman's liability for lost goods. The warehouse receipt is silent on this point. Under the circumstances, Bond is
a. Liable because it was negligent.
b. Liable because it is strictly liable for any loss.
c. Not liable unless Grey can establish that Bond was grossly negligent.
d. Not liable because the warehouse receipt was negotiable.

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>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>Yes</td>
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<td>b. No</td>
<td>Yes</td>
<td>No</td>
</tr>
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<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
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<td>d. Yes</td>
<td>Yes</td>
<td>No</td>
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</table>

C. Sales

Under the UCC Sales Article, which of the following statements is correct concerning a contract involving a merchant seller and a non-merchant buyer?

a. Only the seller is obligated to perform the contract in good faith.
b. The contract will be either a sale or return or sale on approval contract.
c. The contract may not involve the sale of personal property with a price of more than $500.
d. Whether the UCC Sales Article is applicable does not depend on the price of the goods involved.

With respect to the sale of goods, the warranty of title
a. Applies only if the seller is a merchant.
b. Applies only if it is in writing and signed by the seller.
c. Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge when the contract was made.
d. Provides that the seller cannot disclaim the warranty if the sale is made to a bona fide purchaser for value.

Under a contract governed by the UCC Sales Article, which of the following statements is correct?

a. Unless both the seller and the buyer are merchants, neither party is obligated to perform the contract in good faith.
b. The contract will not be enforceable if it fails to expressly specify a time and a place for delivery of the goods.
c. The seller may be excused from performance if the goods are accidentally destroyed before the risk of loss passes to the buyer.
d. If the price of the goods is less than $500, the goods need not be identified to the contract for title to pass to the buyer.

Under the UCC Sales Article, the implied warranty of merchantability
a. May be disclaimed by a seller's oral statement that mentions merchantability.
b. Arises only in contracts involving a merchant seller and a merchant buyer.
c. Is breached if the goods are not fit for all purposes for which the buyer intends to use the goods.
d. Must be part of the basis of the bargain to be binding on the seller.

Yost Corp., a computer manufacturer, contracted to sell 15 computers to Ivor Corp., a computer retailer. The contract specified that delivery was to be made by truck to Ivor's warehouse. Instead, Yost shipped the computers by rail. When Ivor claimed that Yost did not comply with the contract, Yost told Ivor that there had been a trucker's strike when the goods were shipped. Ivor refused to pay for the computers. Under these circumstances, Ivor
a. Is obligated to pay for the computers because Yost made a valid substituted performance.
b. Is obligated to pay for the computers because title to them passed to Ivor when Ivor received them.
c. May return the computers and avoid paying for them because of the way Yost delivered them.
d. May return the computers and avoid paying for them because the contract was void under the theory of commercial impracticability.

Gray Fabricating Co. and Pine Corp. agreed orally that Pine would custom manufacture a processor for Gray at a price of $80,000. After Pine completed the work at a cost of $60,000, Gray notified Pine that the processor was no longer needed. Pine is holding the processor and has requested payment from Gray. Pine has been unable to resell the processor for any price. Pine incurred storage fees of $1,000. If Gray refuses to pay Pine and Pine sues Gray, the most Pine will be entitled to recover is

a. $60,000
b. $61,000
c. $80,000
d. $81,000
Selected Questions

M91#53. To establish a cause of action based on strict liability in tort for personal injuries resulting from using a defective product, one of the elements the plaintiff must prove is that the seller (defendant)
   a. Defectively designed the product.
   b. Was engaged in the business of selling the product.
   c. Was in privity of contract with the plaintiff.
   d. Failed to exercise due care.

M91#54. West purchased a painting from Noll, who is not in the business of selling art. Noll tendered delivery of the painting after receiving payment in full from West. West informed Noll that West would be unable to take possession of the painting until later that day. Thieves stole the painting before West returned. The risk of loss
   a. Remained with Noll, because West had not yet received the painting.
   b. Remained with Noll, because the parties agreed on a later time of delivery.
   c. Passed to West at the time the contract was formed and payment was made.
   d. Passed to West on Noll’s tender of delivery.

M91

Items 55 and 56 are based on the following:

Lazur Corp. agreed to purchase 100 radios from Wizard Suppliers, Inc. Wizard is a wholesaler of small home appliances and Lazur is an appliance retailer. The contract required Wizard to ship the radios to Lazur by common carrier, “F.O.B. Wizard Suppliers, Inc. Loading Dock.”

55. Risk of loss for the radios during shipment to Lazur would be on
   a. Lazur, because the risk of loss passes when the radios are delivered to the carrier.
   b. Wizard, because the risk of loss passes only when Lazur receives the radios.
   c. Wizard, because it is a shipment contract.
   d. Lazur, because title to the radios passes to Lazur at the time of shipment.

56. Under the UCC Sales Article
   a. Title to the radios passes to Lazur at the time they are delivered to the carrier, even if the goods are nonconforming.
   b. Lazur must inspect the radios at the time of delivery or waive any defects and the right to sue for breach of contract.
   c. Wizard must pay the freight expense associated with the shipment of the radios to Lazur.
   d. Lazur would have the right to reject any shipment if Wizard fails to notify Lazur that the goods have been shipped.

M90#40. To satisfy the UCC Statute of Frauds regarding the sale of goods, which of the following must generally be in writing?
   a. Designation of the parties as buyer and seller.
   b. Delivery terms.
   c. Quantity of the goods.
   d. Warranties to be made.

M90#42. Under the UCC Sales Article, the warranty of title may be excluded by
   a. Merchants or non-merchants provided the exclusion is in writing.
   b. Non-merchant sellers only.
   c. The seller’s statement that it is selling only such right or title that it has.
   d. Use of an “as is” disclaimer.

M90#43. An important factor in determining if an express warranty has been created is whether the
   a. Statements made by the seller became part of the basis of the bargain.
   b. Sale was made by a merchant in the regular course of business.
   c. Statements made by the seller were in writing.
   d. Seller intended to create a warranty.

M90#44. Cey Corp. entered into a contract to sell parts to Deck, Ltd. The contract provided that the goods would be shipped “F.O.B. Cey’s warehouse.” Cey shipped parts different from those specified in the contract. Deck rejected the parts. A few hours after Deck informed Cey that the parts were rejected, they were destroyed by fire in Deck’s warehouse. Cey believed that the parts were conforming to the contract. Which of the following statements is correct?
   a. Regardless of whether the parts were conforming, Deck will bear the loss because the contract was a shipment contract.
   b. If the parts were nonconforming, Deck had the right to reject them, but the risk of loss remains with Deck until Cey takes possession of the parts.
   c. If the parts were conforming, risk of loss does not pass to Deck until a reasonable period of time after they are delivered to Deck.
   d. If the parts were nonconforming, Cey will bear the risk of loss, even though the contract was a shipment contract.

M90#45. Pulse Corp. maintained a warehouse where it stored its manufactured goods. Pulse received an order from Star. Shortly after Pulse identified the goods to be shipped to Star, but before moving them to the loading dock, a fire destroyed the warehouse and its contents. With respect to the goods, which of the following statements is correct?
   a. Pulse has title but no insurable interest.
   b. Star has title and an insurable interest.
   c. Pulse has title and an insurable interest.
   d. Star has title but no insurable interest.
M90#46. Jefferson Hardware ordered three hundred Ram hammers from Ajax Hardware. Ajax accepted the order in writing. On the final date allowed for delivery, Ajax discovered it did not have enough Ram hammers to fill the order. Instead, Ajax sent three hundred Strong hammers. Ajax stated on the invoice that the shipment was sent only as an accommodation. Which of the following statements is correct?
   a. Ajax’s note of accommodation cancels the contract between Jefferson and Ajax.
   b. Jefferson’s order can only be accepted by Ajax’s shipment of the goods ordered.
   c. Ajax’s shipment of Strong hammers is a breach of contract.
   d. Ajax’s shipment of Strong hammers is a counteroffer and no contract exists between Jefferson and Ajax.

M90#47. On September 10, Bell Corp. entered into a contract to purchase 50 lamps from Glow Manufacturing. Bell prepaid 40% of the purchase price. Glow became insolvent on September 19 before segregating, in its inventory, the lamps to be delivered to Bell. Bell will not be able to recover the lamps because
   a. Bell is regarded as a merchant.
   b. The lamps were not identified to the contract.
   c. Glow became insolvent fewer than 10 days after receipt of Bell’s prepayment.
   d. Bell did not pay the full price at the time of purchase.

M90#48. DaGama bought a used boat from Magellan Marina, which disclaimed “any and all warranties” in connection with the sale. Magellan was unaware that the boat had been stolen from Colon. DaGama surrendered it to Colon when confronted with proof of the theft. DaGama sued Magellan. Who is likely to prevail and why?
   a. Magellan, because of the general disclaimer.
   b. Magellan, because it was unaware of the theft.
   c. DaGama, because the warranty of title has been breached.
   d. DaGama, because Magellan is a merchant.

M90#49. On Monday, Wolfe paid Aston Co., a furniture retailer, $500 for a table. On Thursday, Aston notified Wolfe that the table was ready to be picked up. On Saturday, while Aston was still in possession of the table, it was destroyed in a fire. Who bears the loss of the table?
   a. Wolfe, because Wolfe had title to the table at the time of loss.
   b. Aston, unless Wolfe is a merchant.
   c. Wolfe, unless Aston breached the contract.
   d. Aston, because Wolfe had not yet taken possession of the table.

M90#50. Mayker, Inc. and Olyco contracted to have Olyco be the exclusive provider of Mayker’s fuel oil for three months. The stated price was subject to increases of up to a total of 10% if the market price increased. The market price rose 25% and Mayker tripled its normal order. Olyco seeks to avoid performance. Olyco’s best argument in support of its position is that
   a. There was no meeting of the minds.
   b. The contract was unconscionable.
   c. The quantity was not definite and certain enough.
   d. Mayker ordered amounts of oil unreasonably greater than its normal requirements.

M90#51. Under the UCC Sales Article, if a buyer wrongfully rejects goods, the aggrieved seller may

Resell the goods and sue for damages  Cancel the agreement

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B-52
M89 #54. With regard to a contract governed by the UCC Sales Article, which one of the following statements is correct?
   a. Merchants and non-merchants are treated alike.
   b. The contract may involve the sale of any type of personal property.
   c. The obligations of the parties to the contract must be performed in good faith.
   d. The contract must involve the sale of goods for a price of more than $500.

M89

Items 55 through 58 are based on the following:

Lazur Corp. entered into a contract with Baker Suppliers, Inc. to purchase a used word processor from Baker. Lazur is engaged in the business of selling new and used word processors to the general public. The contract required Baker to ship the goods to Lazur by common carrier pursuant to the following provision in the contract: "F.O.B. — Baker Suppliers, Inc. loading dock." Baker also represented in the contract that the word processor had been used for only 10 hours by its previous owner. The contract included the provision that the word processor was being sold "as is" and this provision was in a larger and different type style than the remainder of the contract.

55. With regard to the contract between Lazur and Baker,
   a. An implied warranty of merchantability does not arise unless both Lazur and Baker are merchants.
   b. The "as is" provision effectively disclaims the implied warranty of title.
   c. No express warranties are created by the contract.
   d. The "as is" provision would not prevent Baker from being liable for a breach of any express warranties created by the contract.

56. For this item only, assume that during shipment to Lazur the word processor was seriously damaged when the carrier’s truck was involved in an accident. When the carrier attempted to deliver the word processor, Lazur rejected it and has refused to pay Baker the purchase price. Under the UCC Sales Article,
   a. Lazur rightfully rejected the damaged computer.
   b. The risk of loss for the computer was on Lazur during shipment.
   c. At the time of the accident, risk of loss for the computer was on Baker because title to the computer had not yet passed to Lazur.
   d. Lazur will not be liable to Baker for the purchase price of the computer because of the F.O.B. provision in the contract.

57. For this item only, assume that the contract between Lazur and Baker is otherwise silent. Under the UCC Sales Article,
   a. Lazur must pay Baker the purchase price before Baker is required to ship the word processor to Lazur.
   b. Baker does not warrant that it owns the word processor.
   c. Lazur will be entitled to inspect the word processor before it accepts or pays for it.
   d. Title to the word processor passes to Lazur when it takes physical possession.

58. For this item only, assume that Lazur refused to accept the word processor even though it was in all respects conforming to the contract and that the contract is otherwise silent. Under the UCC Sales Article,
   a. Baker can successfully sue for specific performance and make Lazur accept and pay for the word processor.
   b. Baker may resell the word processor to another buyer.
   c. Baker must sue for the difference between the market value of the word processor and the contract price plus its incidental damages.
   d. Baker cannot successfully sue for consequential damages unless it attempts to resell the word processor.

M88 #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.

M88 #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.

M88 #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.
Business Law

N88#46. If goods have been delivered to a buyer pursuant to a sale or return contract, the
a. Buyer may use the goods but not resell them.
b. Seller is liable for the expenses incurred by the buyer in returning the goods to the seller.
c. Title to the goods remains with the seller.
d. Risk of loss for the goods passed to the buyer.

N88#47. Which of the following is necessary in order for the warranty of merchantability to arise where there has been a sale of goods?
I. The seller must be a merchant with respect to goods of that kind.
II. The warranty must be in writing.
III. The buyer must have relied on the seller's skill or judgment in selecting the goods.
   a. I and III only.
   b. I, II, and III.
   c. II and III only.
   d. I only.

N88#48. Cain and Zen Corp. orally agreed that Zen would specially manufacture a machine for Cain at a price of $40,000. After Zen completed the work at a cost of $30,000, Cain notified Zen that it no longer needed the machine. Zen is holding the machine for Cain and has requested payment from Cain. Despite making reasonable efforts, Zen has been unable to resell the machine for any price. Zen has incurred warehouse fees of $500 for storing the machine. If Cain refuses to pay Zen and Zen sues Cain, the most Zen will be entitled to recover is
   a. $0
   b. $30,500
   c. $40,000
   d. $40,500

N88#49. Sutter purchased a computer from Harp. Harp is not in the business of selling computers. Harp tendered delivery of the computer after receiving payment in full from Sutter. Sutter informed Harp that Sutter was unable to take possession of the computer at that time, but would return later that day. Before Sutter returned, the computer was destroyed by a fire.

The risk of loss
   a. Remained with Harp, since title had not yet passed to Sutter.
   b. Passed to Sutter upon Harp's tender of delivery.
   c. Remained with Harp, since Sutter had not yet received the computer.
   d. Passed to Sutter at the time the contract was formed and payment was made.

N88#50. Bean ordered 40 beige refrigerators at list price from Tish Co. Immediately upon receipt of Bean's order, Tish sent Bean an acceptance which was received by Bean. The acceptance indicated that shipment would be made within ten days. On the tenth day Tish discovered that all of its supply of beige refrigerators had been sold. Instead it shipped 40 white refrigerators, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?
   a. Bean's order is a unilateral offer, and can only be accepted by Tish's shipment of the goods ordered.
   b. Tish's shipment of white refrigerators is a counteroffer, thus no contract exists between Bean and Tish.
   c. Tish's note of accommodation cancels the contract between Tish and Bean.
   d. Tish's shipment of white refrigerators constitutes a breach of contract.

N88#51. On March 7, 1988, Wax Corp. contracted with Noll Wholesalers to supply Noll with specific electrical parts. Delivery was called for on June 3, 1988. On May 2, 1988, Wax notified Noll that it would not perform and that Noll should look elsewhere. Wax had received a larger and more lucrative contract on April 21, 1988, and its capacity was such that it could not fulfill both orders. The facts
   a. Will prevent Wax from retracting its repudiation of the Noll contract.
   b. Are not sufficient to clearly establish an anticipatory repudiation.
   c. Will permit Noll to sue only after June 3, 1988, the latest performance date.
   d. Will permit Noll to sue immediately after May 2, 1988, even though the performance called for under the contract was not due until June 3, 1988.

N88#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>
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<tr>
<th>Implied warranty of fitness for a particular purpose</th>
<th>Implied warranty of merchantability</th>
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<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
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<td>b. No</td>
<td>No</td>
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<td>c. Yes</td>
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<td>d. No</td>
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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.
Selected Questions

M87#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

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.

M87#54. If a contract for the sale of goods includes a C. & F. shipping term and the seller has fulfilled all of its obligations, the
   a. Title to the goods will pass to the buyer when the goods are received by the buyer at the place of destination.
   b. Risk of loss will pass to the buyer upon delivery of the goods to the carrier.
   c. Buyer retains the right to inspect the goods prior to making payment.
   d. Seller must obtain an insurance policy at its own expense for the buyer's benefit.

M87#55. Which of the following is most important in determining who bears the risk of loss in a sale of goods contract?
   a. The shipping terms.
   b. The agreement of the parties.
   c. Who has title to the goods.
   d. Who has possession of the goods.

D. Secured Transactions

M91#57. Pix Co., which is engaged in the business of selling appliances, borrowed $18,000 from Lux Bank. Pix executed a promissory note for that amount and pledged all of its customer installment receivables as
collateral for the loan. Pix executed a security agreement that described the collateral, but Lux did not file a financing statement. With respect to this transaction
a. Attachment of the security interest did not occur because Pix failed to file a financing statement.
b. Perfection of the security interest occurred despite Lux’s failure to file a financing statement.
c. Attachment of the security interest took place when the loan was made and Pix executed the security agreement.
d. Perfection of the security interest did not occur because accounts receivable are intangibles.

**M91#58.** Carr Corp. sells VCRs and video tapes to the public. Carr sold and delivered a VCR to Sutter on credit. Sutter executed and delivered to Carr a promissory note for the purchase price and a security agreement covering the VCR. Sutter purchased the VCR for personal use. Carr did not file a financing statement. Is Carr’s security interest perfected?
   a. No, because the VCR was a consumer good.
   b. No, because Carr failed to file a financing statement.
   c. Yes, because Carr retained ownership of the VCR.
   d. Yes, because it was perfected at the time of attachment.

**M91#59.** On June 15, Harper purchased equipment for $100,000 from Imperial Corp. for use in its manufacturing process. Harper paid for the equipment with funds borrowed from Eastern Bank. Harper gave Eastern a security agreement and financing statement covering Harper’s existing and after-acquired equipment. On June 21, Harper was petitioned involuntarily into bankruptcy under Chapter 7 of the Federal Bankruptcy Code. A bankruptcy trustee was appointed. On June 23, Eastern filed the financing statement. Which of the parties will have a superior security interest in the equipment?
   a. The trustee in bankruptcy, because the filing of the financing statement after the commencement of the bankruptcy case would be deemed a preferential transfer.
   b. The trustee in bankruptcy, because the trustee became a lien creditor before Eastern perfected its security interest.
   c. Eastern, because it had a perfected purchase money security interest without having to file a financing statement.
   d. Eastern, because it perfected its security interest within the permissible time limits.

**M91#60.** Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine’s personal investments. Later, Wine sold the computer to Jacobs, for Jacobs’ family use. Jacobs was unaware of MJC’s security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?
   a. No, because Jacobs was unaware of the MJC security interest.
   b. No, because Jacobs intended to use the computer for family or household purposes.
   c. Yes, because MJC’s security interest was perfected before Jacobs’ purchase.
   d. Yes, because Jacobs’ purchase of the computer made Jacobs personally liable to MJC.

**M90#49.** Sun, Inc. manufactures and sells household appliances on credit directly to wholesalers, retailers, and consumers. Sun can perfect its security interest in the appliances without having to file a financing statement or take possession of the appliances if the sale is made by Sun to
   a. Consumers.
   b. Wholesalers that sell to buyers in the ordinary course of business.
   c. Retailers.
   d. Wholesalers that sell to distributors for resale.

**M90#51.** Vista is a wholesale seller of microwave ovens. Vista sold 50 microwave ovens to Davis Appliance for $20,000. Davis paid $5,000 down and signed a promissory note for the balance. Davis also executed a security agreement giving Vista a security interest in Davis’ inventory, including the ovens. Vista perfected its security interest by properly filing a financing statement in the state of Whiteacre. Six months later, Davis moved its business to the state of Blackacre, taking the ovens. On arriving in Blackacre, Davis secured a loan from Grange Bank and signed a security agreement putting up all inventory (including the ovens) as collateral. Grange perfected its security interest by properly filing a financing statement in the state of Blackacre. Two months after arriving in Blackacre, Davis went into default on both debts. Which of the following statements is correct?
   a. Grange’s security interest is superior because Grange had no actual notice of Vista’s security interest.
   b. Vista’s security interest is superior even though at the time of Davis’ default Vista had not perfected its security interest in the state of Blackacre.
   c. Grange’s security interest is superior because Vista’s time to file a financing statement in Blackacre had expired prior to Grange’s filing.
   d. Vista’s security interest is superior provided it repossesses the ovens before Grange does.
Selected Questions

N89#50. Under the UCC Secured Transactions Article, for a security interest to attach, the
a. Debtor must agree to the creation of the security interest.
b. Creditor must properly file a financing statement.
c. Debtor must be denied all rights in the collateral.
d. Creditor must take and hold the collateral.

N89#53. Perfection of a security interest permits the secured party to protect its interest by
a. Avoiding the need to file a financing statement.
b. Preventing another creditor from obtaining a security interest in the same collateral.
c. Establishing priority over the claims of most subsequent secured creditors.
d. Denying the debtor the right to possess the collateral.

N89#54. Roth and Dixon both claim a security interest in the same collateral. Roth's security interest attached on January 1, 1989, and was perfected by filing on March 1, 1989. Dixon's security interest attached on February 1, 1989, and was perfected on April 1, 1989, by taking possession of the collateral. Which of the following statements is correct?
a. Roth's security interest has priority because Roth perfected before Dixon perfected.
b. Dixon's security interest has priority because Dixon's interest attached before Roth's interest was perfected.
c. Roth's security interest has priority because Roth's security interest attached before Dixon's security interest attached.
d. Dixon's security interest has priority because Dixon is in possession of the collateral.

N89#55. Under the UCC Secured Transactions Article, if a debtor is in default under a payment obligation secured by goods, the secured party has the right to

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<tr>
<th>Reduce the claim to a</th>
<th>Sell the goods</th>
<th>Take possession of the goods</th>
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<tr>
<td>judgment and apply the proceeds toward the debt</td>
<td></td>
<td>without judicial process</td>
</tr>
<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
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<td>b. Yes</td>
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<td>Yes</td>
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<td>c. No</td>
<td>Yes</td>
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<td>d. Yes</td>
<td>Yes</td>
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N89#47. Acorn Marina, Inc. sells and services boat motors. On April 1, 1989, Acorn financed the purchase of its entire inventory with GAC Finance Company. GAC required Acorn to execute a security agreement and financing statement covering the inventory and proceeds of sale. On April 14, 1989, GAC properly filed the financing statement pursuant to the UCC Secured Transactions Article. On April 27, 1989, Acorn sold one of the motors to Wilks for use in his charter business. Wilks, who had once worked for Acorn, knew that Acorn regularly financed its inventory with GAC. Acorn has defaulted on its obligations to GAC. The motor purchased by Wilks is
a. Subject to the GAC security interest because Wilks should have known that GAC financed the inventory purchase by Acorn.
b. Subject to the GAC security interest because Wilks purchased the motor for a commercial use.
c. Not subject to the GAC security interest because Wilks is regarded as a buyer in the ordinary course of Acorn's business.
d. Not subject to the GAC security interest because GAC failed to file the financing statement until more than 10 days after April 1, 1989.

N89#60. Burn Manufacturing borrowed $500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to
a. Both Burn and Green.
b. Neither Burn nor Green.
c. Burn but not Green.
d. Green but not Burn.

N89#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.

N89#53. Dart Co., which is engaged in the business of selling appliances, borrowed $8,000 from Arco Bank. Dart executed a promissory note for that amount and pledged all of its customer installment receivables as collateral for the loan. Dart executed a security
agreement which described the collateral, but Arco did not file a financing statement. With respect to this transaction
a. Attachment of the security interest took place when Dart executed the security agreement.
b. Attachment of the security interest did not occur because Arco failed to file a financing statement.
c. Perfection of the security interest occurred despite Arco’s failure to file a financing statement.
d. The UCC Secured Transactions Article does not apply because Arco failed to file a financing statement.

N88#54. With regard to a prior perfected security interest in goods for which a financing statement has been filed, which of the following parties is most likely to have a superior interest in the same collateral?
a. A buyer in the ordinary course of business who purchased the goods from a merchant.
b. A subsequent buyer of consumer goods who purchased the goods from another consumer.
c. The trustee in bankruptcy of the debtor.
d. Lien creditors of the debtor.

N88#55. Bonn, a secured party, sells collateral at a private sale to a good faith purchaser for value after the debtor defaults. Which of the following statements is correct under the UCC Secured Transactions Article?
a. In all cases, the collateral will remain subject to the security interests of subordinate lien creditors.
b. The security interest under which the sale was made and any security interest or lien subordinate to it will be discharged.
c. In all cases, Bonn may not buy the collateral at a private sale.
d. Bonn will be entitled to receive a first priority in the sale proceeds.

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.

N87#56. 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.

N87#59. If a manufacturer assigns 90% of its accounts receivable to a factor, perfection will occur by

<table>
<thead>
<tr>
<th>Filing a financing statement</th>
<th>Possession</th>
<th>Attachment</th>
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<tr>
<td>a. Yes</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>b. Yes</td>
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<td>No</td>
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<td>c. No</td>
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<td>Yes</td>
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<td>d. No</td>
<td>Yes</td>
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N87#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 com-
Selected Questions

A. Real and Personal Property

M90#51. Jones and Newton each own a one-half interest in certain real property as tenants in common. Jones' interest
   a. Will pass by operation of law to Newton on Jones' death.
   b. Will pass on Jones' death to Jones' heirs.
   c. May not be transferred during Jones' lifetime.
   d. Is considered a life estate.

M90#52. Bronson is a residential tenant with a 10-year written lease. In the absence of specific provisions in the lease to the contrary, which of the following statements is correct?
   a. The premises may not be sublet for less than the full remaining lease term.
   b. Bronson may not assign the lease.
   c. The landlord's death will automatically terminate the lease.
   d. Bronson's purchase of the property will terminate the lease.

M90#53. Unless an exception to title is noted in the title insurance policy, a title insurance company will be liable to a land purchaser for
   a. Closing costs.
   b. Recorded easements.
   c. Unrecorded assessments.
   d. Zoning violations.

M90#56. Which of the following deeds will give a real property purchaser the greatest protection?
   a. Quitclaim.
   b. Bargain and sale.
   c. Special warranty.
   d. General warranty.

M90#50. A person may own property as a joint tenant with the right of survivorship with any of the following except (an)
   a. Divorced spouse.
   b. Related minor child.
   c. Unaffiliated corporation.
   d. Unrelated adult.

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.

VII. Property

M90#52. Ivor, Queen, and Lear own a building as joint tenants with the right of survivorship. Ivor donated his interest in the building to Day Charity by executing and delivering a deed to Day. Both Queen and Lear refused to consent to Ivor's transfer to Day. Subsequently, Queen and Lear died. After their deaths, Day's interest in the building consisted of
   a. Total ownership due to the deaths of Queen and Lear.
   b. No interest because Queen and Lear refused to consent to the transfer.
   c. A ½ interest as a joint tenant.
   d. A ½ interest as a tenant in common.

M90#53. A tenant renting an apartment under a three-year written lease that does not contain any specific restrictions may be evicted for
   a. Counterfeiting money in the apartment.
   b. Keeping a dog in the apartment.
   c. Failing to maintain a liability insurance policy on the apartment.
   d. Making structural repairs to the apartment.

M90#54. Delta Corp. leased 60,000 square feet in an office building from Tanner under a written 25-year lease. Which of the following statements is correct?
   a. Tanner's death will terminate the lease and Delta will be able to recover any resulting damages from Tanner's estate.
   b. Tanner's sale of the office building will terminate the lease unless both Delta and the buyer consented to the assumption of the lease by the buyer.
   c. In the absence of a provision in the lease to the contrary, Delta does not need Tanner's consent to assign the lease to another party.
   d. In the absence of a provision in the lease to the contrary, Delta would need Tanner's consent to enter into a sublease with another party.

M90#55. On February 2, Mazo deeded a warehouse to Parko for $450,000. Parko did not record the deed. On February 12, Mazo deeded the same warehouse to Nexis for $430,000. Nexis was aware of the prior con-
veyance to Parko. Nexis recorded its deed before Parko recorded. Who would prevail under the following recording statutes?

<table>
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<tr>
<th>Notice statute</th>
<th>Race statute</th>
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<tbody>
<tr>
<td>a. Nexis</td>
<td>Parko</td>
<td>Parko</td>
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<td>b. Parko</td>
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<tr>
<td>c. Parko</td>
<td>Nexis</td>
<td>Nxis</td>
</tr>
<tr>
<td>d. Parko</td>
<td>Parko</td>
<td>Nxis</td>
</tr>
</tbody>
</table>

N88#56. A buyer of real estate who receives a title insurance policy will
a. Take title free of all defects.

b. Be able to transfer the policy to a subsequent buyer of the real estate.

c. Not have coverage for title exceptions listed in the insurance policy.

d. Not have coverage greater than the amount of any first mortgage.

N88#56. Green and Nunn own a 40-acre parcel of land as joint tenants with the right of survivorship. Nunn wishes to sell the land to Ink. If Nunn alone executes and delivers a deed to Ink, what will be the result?

a. Green will retain a 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.

N88#57. Tell, Inc. leased a building from Lott Corp. Tell paid monthly rent of $500 and was also responsible for paying the building's real estate taxes. On January 1, 1987, Vorn Co. and Tell entered into an agreement by which Vorn was entitled to occupy the building for the remainder of the term of Tell's lease in exchange for monthly payments of $600 to Tell. For the year 1987, neither Tell nor Vorn paid the building's real estate taxes and the taxes are delinquent. Learning this, Lott demanded that either Tell or Vorn pay the delinquent taxes. Both refused to do so and Lott has commenced an action against them. Lott will most likely prevail against

a. Vorn because the lease was assigned to it.

b. Tell and Vorn because both are jointly and severally liable for the delinquent taxes.

c. Tell without Vorn because their January 1 agreement constituted a sublease.

d. Vorn but only to the extent of $100 for each month that it occupied the building during 1987.

N88#58. Which of the following deeds gives the grantee the least amount of protection?

a. Bargain and sale deed.

b. Grant deed.

c. Quitclaim deed.

d. Warranty deed.

N88#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

N97#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.

N97

Items 54 and 55 are based on the following information:

Hill, Knox, and Lark own a building as joint tenants with the right of survivorship. Hill donated her interest in the building to Care Charity by executing and delivering a deed to Care. Both Knox and Lark refused to consent to Hill’s transfer to Care. Subsequently, Hill and Knox died.

54. As a result of Hill’s transfer to Care, Care acquired
   a. A ½ interest in the building as a joint tenant.
   b. A ½ interest in the building as a tenant in common.
   c. No interest in the building because Knox and Lark refused to consent to the transfer.
   d. No interest in the building because it failed to qualify as a bona fide purchaser for value.

55. As a result of Hill’s and Knox’s death,
   a. Lark owns the entire interest in the building.
   b. Lark owns a ½ interest in the building as a tenant in common.
   c. Care and Lark each own a ½ interest in the building as joint tenants.
   d. Knox’s heirs and Lark each own a ½ interest in the building as tenants in common.

N97#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.

N97#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.

B. Mortgages

N90#54. Sklar Corp. owns a factory that has a fair market value of $90,000. Dall Bank holds an $80,000 first mortgage and Rice Finance holds a $20,000 second mortgage on the factory. Sklar has discontinued payments to Dall and Rice, who have foreclosed on their mortgages. If the factory is properly sold to Bond at a judicial sale for $90,000, after expenses,
   a. Rice will receive $10,000 out of the proceeds.
   b. Dall will receive $77,500 out of the proceeds.
   c. Bond will take the factory subject to the unsatisfied portion of any mortgage.
   d. Rice has a right of redemption after the judicial sale.

N90#55. To be enforceable against the mortgagor, a mortgage must meet all the following requirements except
   a. Be delivered to the mortgagor.
   b. Be in writing and signed by the mortgagor.
   c. Be recorded by the mortgagor.
   d. Include a description of the debt and land involved.

N90#56. Ritz owned a building on which there was a duly recorded first mortgage held by Lyn and a recorded second mortgage held by Jay. Ritz sold the building to Nunn. Nunn assumed the Jay mortgage and had no actual knowledge of the Lyn mortgage. Nunn defaulted on the payments to Jay. If both Lyn and Jay foreclosed, and the proceeds of the sale were insufficient to pay both Lyn and Jay,
   a. Jay would be paid after Lyn was fully paid.
   b. Jay and Lyn would be paid proportionately.
   c. Nunn would be personally liable to Lyn but not to Jay.
   d. Nunn would be personally liable to Lyn and Jay.

N90#59. Gilmore borrowed $60,000 from Dix Bank. The loan was used to remodel a building owned by Gilmore as investment property and was secured by a
second mortgage that Dix did not record. FCA Loan Company has a recorded first mortgage on the building. If Gilmore defaults on both mortgages, Dix
a. Will not be entitled to any mortgage foreclosure sale proceeds, even if such proceeds are in excess of the amount owed to FCA.
b. Will be unable to successfully claim any security interest in the building.
c. Will be entitled to share in any foreclosure sale proceeds pro rata with FCA.
d. Will be able to successfully claim a security interest that is subordinate to FCA’s security interest.

NS90#56. On April 6, Ford purchased a warehouse from Atwood for $150,000. Atwood had executed two mortgages on the property: a purchase money mortgage given to Lang on March 2, which was not recorded; and a mortgage given to Young on March 9, which was recorded the same day. Ford was unaware of the mortgage to Lang. Under the circumstances,
a. Ford will take title to the warehouse subject only to Lang’s mortgage.
b. Ford will take title to the warehouse free of Lang’s mortgage.
c. Lang’s mortgage is superior to Young’s mortgage because Lang’s mortgage is a purchase money mortgage.
d. Lang’s mortgage is superior to Young’s mortgage because Lang’s mortgage was given first in time.

NS90#57. Sussex, Inc. had given a first mortgage when it purchased its plant and warehouse. Sussex needed additional working capital. It decided to obtain financing by giving a second mortgage on the plant and warehouse. Which of the following statements is true with respect to the mortgages?
a. Default on payment of the second mortgage will constitute default on the first mortgage.
b. The second mortgage may not be prepaid without the consent of the first mortgagee.
c. The second mortgagee may not pay off the first mortgage to protect its security.
d. If both mortgages are foreclosed, the first mortgage must be fully paid before paying the second mortgage.

NS90#58. If a mortgagor defaults in the payment of a purchase money mortgage, and the mortgagee forecloses, the mortgagor may do any of the following except
a. Obtain any excess monies resulting from a judicial sale after payment of the mortgagee.
b. Remain in possession of the property after a foreclosure sale if the equity in the property exceeds the balance due on the mortgage.
c. Refinance the mortgage with another lender and repay the original mortgagee.
d. Assert the equitable right of redemption by paying the mortgagee.

NS90#57. If a borrower is in default under a purchase money mortgage loan, the
a. Lender can file suit to have the borrower declared insolvent.
b. Person who sold the real estate to the borrower can be forced to assume the mortgage debt.
c. Lender may file suit for foreclosure.
d. Lender may unilaterally obtain title without a foreclosure suit.

NS90#58. Ram Corp. owns a warehouse that has a fair market value of $280,000. Area Bank holds a first mortgage and Public Finance holds a second mortgage on the warehouse. Ram has discontinued payments to Area and Public. As a result, Area, which has an outstanding mortgage of $240,000, and Public, which has an outstanding mortgage of $60,000, have foreclosed on their respective mortgages. If the warehouse is properly sold to Quincy at a judicial sale for $280,000, after expenses,
a. Public will receive $40,000 out of the proceeds.
b. Area will receive $224,000 out of the proceeds.
c. Public has a right of redemption after the judicial sale.
d. Quincy will take the warehouse subject to the unsatisfied portion of any mortgage.

NS90#59. In general, a mortgage on real estate
a. Must be recorded to validate the mortgagee’s (lender’s) rights against the mortgagor (borrower).
b. Must be signed by the mortgagee and mortgagor to create an enforceable instrument.
c. Encumbers the mortgagor’s legal title to the real estate.
d. Gives the mortgagee the right to possess the real estate.

NS90#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.
Selected Questions

**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 mortgagor may assign the mortgage to a third party without the mortgagor's consent.

c. The mortgage need not contain a description of the real estate covered by the mortgage.

d. The mortgage must contain the actual amount of the underlying debt and the rate of interest.

**M88#56.** Bell obtained a $30,000 loan from Arco Bank, executing a promissory note and mortgage. The loan was secured by a building that Bell purchased from Marx for $50,000. Arco's recording of the mortgage

a. Generally does not affect the rights of Bell and Arco against each other under the promissory note.

b. Generally creates a possessory security interest in Arco.

c. Cuts off the rights of all prior and subsequent lessees of the building.

d. Transfers legal title to the building to Arco.

**M88#57.** On April 6, 1988, Walsh purchased a warehouse from Bock for $150,000. Best Title Co. had performed a title search of the property. The results of the title search indicated that a mortgage given to Stone by Bock was duly recorded against the warehouse on March 9, 1988. However, the title search failed to detect a purchase money mortgage dated March 2, 1988, given by Bock to Todd. This mortgage was never recorded. Walsh was unaware of the mortgage to Todd. Under the circumstances,

a. Walsh will take title to the warehouse subject to Todd's mortgage because it is a purchase money mortgage.

b. Walsh will take title to the warehouse free of Todd's mortgage.

c. Todd's mortgage is superior to Stone's mortgage.

d. Best will be liable to Walsh because of its failure to detect the Todd mortgage.

**M87#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.

**M87#52.** Lusk borrowed $20,000 from Marco Finance. The loan was secured by a mortgage on a four-unit apartment building owned by Lusk. The proceeds of the loan were used by Lusk to purchase a business. The mortgage was duly recorded 60 days after Marco loaned the money to Lusk. Six months after borrowing the money from Marco, Lusk leased one of the apartments to Rudd for $800 per month. Neither Rudd nor Lusk notified Marco of the lease. Subsequently, Lusk defaulted on the note to Marco and Marco has commenced foreclosure proceedings. Under the circumstances,

a. Marco's mortgage is junior to Rudd's lease because the mortgage was not a purchase money mortgage.

b. Marco's mortgage is junior to Rudd's lease because Marco failed to record the mortgage for 60 days after the closing.

c. Rudd's lease is subject to Marco's mortgage because Marco recorded its mortgage prior to the time Rudd's leasehold interest arose.

d. Rudd's lease is subject to Marco's mortgage because of the failure to notify Marco of the lease.

**C. Fire and Casualty Insurance**

**M90#57.** One of the primary purposes of including a coinsurance clause in a property insurance policy is to

a. Encourage the policyholder to insure the property for an amount close to its full value.

b. Make the policyholder responsible for the entire loss caused by some covered perils.

c. Cause the policyholder to maintain a minimum amount of liability insurance that will increase with inflation.

d. Require the policyholder to insure the property with only one insurance company.

**M90#60.** On February 1, Papco Corp. entered into a contract to purchase an office building from Merit Company for $500,000 with closing scheduled for March 20. On February 2, Papco obtained a $400,000 standard fire insurance policy from Abe Insurance Company. On March 15, the office building sustained a $90,000 fire loss. On March 15, which of the following is correct?

I. Papco has an insurable interest in the building.

II. Merit has an insurable interest in the building.

a. I only.

b. II only.

c. Both I and II.

d. Neither I nor II.

**M90#59.** Lawfo Corp. maintains a $200,000 standard fire insurance policy on one of its warehouses. The policy includes an 80% coinsurance clause. At the time the warehouse was originally insured, its value was
$250,000. The warehouse now has a value of $300,000. If the warehouse sustains $30,000 of fire damage, Law-fo's insurance recovery will be a maximum of
a. $20,000
b. $24,000
c. $25,000
d. $30,000

M90#60. Orr is an employee of Vick Corp. Vick relies heavily on Orr's ability to market Vick's products and, for that reason, has acquired a $50,000 insurance policy on Orr's life. Half of the face value of the policy is payable to Vick and the other half is payable to Orr's spouse. Orr dies shortly after the policy is taken out but after leaving Vick's employ. Which of the following statements is correct?
   a. Orr's spouse does not have an insurable interest because the policy is owned by Vick.
   b. Orr's spouse will be entitled to all of the proceeds of the policy.
   c. Vick will not be entitled to any of the proceeds of the policy because Vick is not a creditor or relative of Orr.
   d. Vick will be entitled to its share of the proceeds of the policy regardless of whether Orr is employed by Vick at the time of death.

M89#59. McArthur purchased a house for $60,000. The house is insured for $64,000 and the insurance policy has an 80% coinsurance provision. Storms caused $12,000 worth of damage when the house had a fair market value of $120,000. What maximum amount will McArthur recover from the insurance company?
   a. $ 8,000.
   b. $ 9,000.
   c. $ 9,600.
   d. $12,000.

M88#60. To recover under a property insurance policy, an insurable interest must exist

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<tr>
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<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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M88#59. On April 2, 1987, Ritz Corp. purchased a warehouse that it insured for $500,000. The policy contained a 75% coinsurance clause. On April 25, 1988, a fire caused $900,000 damage to the warehouse. The fair market value of the warehouse was $800,000 on April 2, 1987, and $1 million on April 25, 1988. Ritz is entitled to receive insurance proceeds of, at most,
   a. $375,000.
   b. $500,000.
   c. $600,000.
   d. $750,000.

M86#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?

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<tr>
<th>Tenant</th>
<th>Mortgage</th>
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<tr>
<td>a. Yes</td>
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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
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M87#68. 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.

M87#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.

M87#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.
SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law

| Liability to Clients | N87#26 d | M88# 8 c | N87#27 d | M88# 9 b |
| N90# 1 c | N87#28 c | N87#31 d | N87#29 d | N87#32 a |
| N90# 2 b | N87#30 b | N87#33 b | N87#34 b |

B. Federal Statutory

| Liability | N90# 6 a | N90# 7 b | N90# 8 c | N90# 3 d |
| N90# 1 b | N89# 6 a | N90# 3 d | N90# 4 a | N90# 5 d |
| N90# 2 b | N89# 8 c | N89# 10 a | N87#35 c |

C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations

A. Agency

| M87# 4 d | N87#21 b | M87# 1 d |
| M87# 5 a | N87#22 c | M87# 2 c |
| M87# 6 d | M87# 7 c | M87# 8 a |

B. Partnerships and Joint Ventures

| N90# 11 a | C. Corporations | N90# 17 b | M91# 8 b |
| N90# 12 c | N90# 13 c | M91# 9 a | M91# 9 c |
| N90# 14 b | N90# 14 c | M91# 10 d | N90# 20 d |
| N90# 5 d | N90# 5 d | M90# 11 a | N89# 8 c |
| N90# 6 b | N90# 6 b | M90# 12 c | M90# 13 a |
| N90# 7 d | N90# 15 d | M90# 14 c | M90# 15 d |
| N89# 1 a | N90# 16 b | M89# 17 a | M89# 17 b |
| N89# 2 b | N89# 17 b | M89# 18 a | M89# 18 d |
| N89# 3 b | N90# 18 b | N89# 18 c | M89# 19 a |
| M89#11 b | N90# 18 c | M90# 19 b | M90# 20 c |
| M89#12 b | N90# 19 d | N88# 6 a | M88#20 c |
| M89#13 c | N89# 2 a | N89# 6 b | M88#10 b |
| N89# 1 a | N89# 3 d | N88# 7 c | M88#12 c |
| N89# 2 a | M89#15 d | N88# 8 c | N88# 16 d |
| N89# 3 a | M89#16 a | N88# 9 c | N87#17 d |
| M88# 4 a | N88# 4 a | N88# 10 b | N87#18 c |
| M88# 5 d | M88# 7 a | M88#12 c | |
| M88# 6 b | M88#13 c | M88#15 c | |

III. Estates and Trusts

| M88#14 d | N87#23 b | N87#24 b | N87#25 a |
| M88#14 d | N87#19 b | N87#20 b | N87#20 b |
| M88#15 c | N87#17 c | N87#18 c | N87#18 c |
III. Contracts

A. Offer and Acceptance
B. Consideration
C. Capacity, Legality, and Public Policy
D. Statute of Frauds
E. Statute of Limitations
F. Fraud, Duress, and Undue Influence
G. Mistake and Misrepresentation
H. Parol Evidence Rule
I. Third Party Rights
J. Assignments
K. Discharge, Breach, and Remedies

IV. Debtor-Creditor Relationships

A. Suretyship
B. Bankruptcy
Unofficial Answers

V. Government Regulation of Business

A. Regulation of Employment

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B. Federal Securities Acts

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VI. Uniform Commercial Code

A. Commercial Paper

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B. Documents of Title and Investment Securities

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C. Sales

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D. Secured Transactions

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B-67
### VII. Property

#### A. Real and Personal Property

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#### B. Mortgages

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#### C. Fire and Casualty Insurance

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ESSAYS — SELECTED QUESTIONS

I. The CPA and the Law

M91

Number 5 (Estimated time — — 15 to 20 minutes)

Sleek Corp. is a public corporation whose stock is traded on a national securities exchange. Sleek hired Garson Associates, CPAs, to audit Sleek's financial statements. Sleek needed the audit to obtain bank loans and to make a public stock offering so that Sleek could undertake a business expansion program.

Before the engagement, Fred Hedge, Sleek's president, told Garson's managing partner that the audited financial statements would be submitted to Sleek's banks to obtain the necessary loans.

During the course of the audit, Garson's managing partner found that Hedge and other Sleek officers had embezzled substantial amounts of money from the corporation. These embezzlements threatened Sleek's financial stability. When these findings were brought to Hedge's attention, Hedge promised that the money would be repaid and begged that the audit not disclose the embezzlements.

Hedge also told Garson's managing partner that several friends and relatives of Sleek's officers had been advised about the projected business expansion and proposed stock offering, and had purchased significant amounts of Sleek's stock based on this information.

Garson submitted an unqualified opinion on Sleek's financial statements, which did not include adjustments for or disclosures about the embezzlements and insider stock transactions. The financial statements and audit report were submitted to Sleek's regular banks including Knox Bank. Knox, relying on the financial statements and Garson's report, gave Sleek a $2,000,000 loan.

Sleek's audited financial statements were also incorporated in a registration statement prepared under the provisions of the Securities Act of 1933. The registration statement was filed with the SEC in conjunction with Sleek's public offering of 100,000 shares of its common stock at $100 per share.

An SEC investigation of Sleek disclosed the embezzlements and the insider trading. Trading in Sleek's stock was suspended and Sleek defaulted on the Knox loan.

As a result, the following legal actions were taken:

• Knox sued Garson.

• The general public purchasers of Sleek's stock offerings sued Garson.

Required:

Answer the following questions and give the reasons for your conclusions.

a. Would Knox recover from Garson for fraud?

b. Would the general public purchasers of Sleek's stock offerings recover from Garson?

1. Under the liability provisions of Section 11 of the Securities Act of 1933?

2. Under the anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934?

M90

Number 3 (Estimated time — — 15 to 20 minutes)

Astor Electronics, Inc. is engaged in the business of marketing a wide variety of computer-related products throughout the United States. Astor's officers decided to raise $1,000,000 by selling shares of Astor's common stock in an exempt offering under Regulation D of the Securities Act of 1933. In connection with the offering, Astor engaged Apple & Co., CPAs, to audit Astor's 1989 financial statements. The audited financial statements, including Apple's unqualified opinion, were included in the offering memorandum given to prospective purchasers of Astor's stock. Apple was aware that Astor intended to include the statements in the offering materials.

On Astor's financial statements, certain inventory items were reported at a cost of $930,000 when, in fact, they had a fair market value of less than $100,000 because of technological obsolescence. Apple accepted the assurances of Astor's controller that cost was the appropriate valuation, despite the fact that Apple was aware of ongoing sales of the products at prices substantially less than cost. All of this was thoroughly documented in Apple's working papers.

Musk purchased 10,000 shares of Astor's common stock in the Regulation D offering at a total price of $300,000. In deciding to make the purchase, Musk had reviewed the audited financial statements of Astor that accompanied the other offering materials and Musk was impressed by Astor's apparent financial strength.

Shortly after the stock offering was completed, Astor's management discovered that the audited financial statements reflected the materially overstated valuation of the company's inventory. Astor advised its shareholders of the problem.
Musk, upon receiving notice from Astor of the overstated inventory amount, became very upset because the stock value was now substantially less than what it would have been had the financial statements been accurate. In fact, the stock is worth only about $200,000.

Musk has commenced an action against Apple alleging that Apple is liable to Musk based on the following causes of action:

- Common law fraud.
- Negligence.
- A violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

During the course of the litigation, Apple has refused to give to Musk its working papers pertaining to the Astor audit, claiming that these constituted privileged communications. The state in which the actions have been commenced has no accountants' privileged communication statute.

The state law applicable to this action follows the Ultramare decision with respect to accountants' liability to third parties for negligence or fraud.

Apple has also asserted that the actions should be dismissed because of the absence of any contractual relationship between Apple and Musk, i.e., a lack of privity.

Required:

Answer the following, setting forth reasons for any conclusions stated.

a. Will Apple be required to give Musk its working papers?

b. What elements must be established by Musk to support his cause of action based on negligence?

c. What elements must be established by Musk to support his cause of action based on a Rule 10b-5 violation?

d. Is Apple's assertion regarding lack of privity correct with regard to Musk's causes of action for negligence and fraud?

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.

**M86**

**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.

**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.

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.
**Business Law**

**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?

**II. Business Organizations**

**A. Agency**

**N90**

Number 3 (Estimated time — 15 to 20 minutes)

Prime Cars, Inc. buys and sells used automobiles. Occasionally Prime has its salespeople purchase used cars from third parties without disclosing that the salesperson is in fact buying for Prime's used car inventory. Prime's management believes better prices can be negotiated using this procedure. One of Prime's salespeople, Peterson, entered into a contract with Hallow in accordance with instructions from Prime's sales manager. The car was to be delivered one week later. After entering into the contract with Hallow, and while driving back to Prime's place of business, Peterson was involved in an automobile accident with another vehicle. Peterson's negligence, and the resulting collision, injured Mathews, the driver of the other car involved in the accident.

Prime terminated Peterson's employment because of the accident. Following Prime's general business practices, Prime published an advertisement in several trade journals that gave notice that Peterson was no longer employed by Prime. Shortly thereafter, Peterson approached one of Prime's competitors, Bagley Autos, Inc., and contracted to sell Bagley several used cars in Prime's inventory. Bagley's sales manager, who frequently purchased cars out of Prime's inventory from Peterson, paid 25% of the total price to Peterson, with the balance to be paid ten days later when the cars were to be delivered. Bagley's sales manager was unaware of Peterson's termination. Prime refused to deliver the cars to Bagley or to repay Bagley's down payment, which Prime never received from Peterson.

Prime also refused to go through with the contract entered into by Peterson with Hallow. Mathews sued both Peterson and Prime for the injuries sustained in the automobile accident. Bagley sued Prime for failing to deliver the cars or return the down payment paid to Peterson.

**Required:**

Answer each of the following questions, setting forth the reasons for your conclusions.

a. What rights does Hallow have against Prime or Peterson?

b. Will Mathews prevail in the lawsuit against Prime and Peterson?

c. Will Bagley prevail in its lawsuit against Prime?

**B. Partnerships and Joint Ventures**

**N91**

Number 2 (Estimated time — 15 to 20 minutes)

Prime Cars Partnership is a general partnership engaged in the business of buying, selling, and servicing used cars. Prime's original partners were Baker and Mathews, who formed the partnership three years ago under a written partnership agreement, which provided that:

- Profits and losses would be allocated 60% to Baker and 40% to Mathews.
- Baker would be responsible for supervising Prime's salespeople and for purchasing used cars for inventory. Baker could not, without Mathews' consent, enter into a contract to purchase more than $15,000 worth of used cars at any one time.
- Mathews would be responsible for supervising Prime's service department.

On May 1, 1990, Baker entered into a contract on Prime's behalf with Jaco Auto Wholesalers, Inc. to purchase 11 used cars from Jaco for a total purchase price of $40,000. Baker's agreement with Jaco provided that the cars would be delivered to Prime on September 1. Baker did not advise Mathews of the terms and conditions of the contract with Jaco. Baker had regularly done business with Jaco on behalf of Prime in the past, and on several occasions had purchased $12,000 to $15,000 of used cars from Jaco. Jaco was unaware of the limitation on Baker's authority.

Baker also frequently purchased used cars for Prime from Top Auto Auctions, Ltd., a corporation owned by Baker's friend. Whenever Prime purchased
Selected Questions

cars from Top, Baker would personally receive up to 5% of the total purchase price from Top as an incentive to do more business with Top. Baker did not tell Mathews about these payments.

On August 1, 1990, Baker and Mathews agreed to admit KYA Auto Restorers, Inc. as a partner in Prime to start up and supervise a body shop facility. KYA made a $25,000 capital contribution and Prime’s partnership agreement was amended to provide that Prime's profits and losses would be shared equally by the partners.

On September 1, 1990, Mathews learned of the Jaco contract and refused to accept delivery of the cars. Mathews advised Jaco that Baker had entered into the contract without Mathews' consent as required by their agreement. Jaco has demanded a payment of $10,000 from Prime for Jaco's lost profits under the contract.

Mathews has also learned about the incentive payments made to Baker by Top.

Mathews has taken the following positions:

- Prime is not liable to Jaco because Baker entered into the contract without Mathews' consent.
- In any event, Mathews is not liable to Jaco for more than 40% of Jaco's lost profits because of the original partnership provisions concerning the sharing of profits and losses.
- Baker is liable to Mathews for any liability incurred by Mathews under the Jaco contract.
- Baker is liable to Prime for accepting the incentive payments from Top.

KYA contends that none of its $25,000 capital contribution should be applied to the Jaco liability and that, in any event, KYA does not have any responsibility for the obligation.

Required:

a. State whether Mathews' positions are correct and give the reasons for your conclusions.

b. State whether KYA's contentions are correct and give the reasons for your conclusions.

M90
Number 4 (Estimated time — 15 to 20 minutes)

Smith, Edwards, and Weil formed Sterling Properties Limited Partnership to engage in the business of buying, selling and managing real estate. Smith and Edwards were general partners. Weil was a limited partner entitled to 50% of all profits.

Within a few months of Sterling's formation, it became apparent to Weil that Smith's and Edwards' inexperience was likely to result in financial disaster for the partnership. Therefore, Weil became more involved in day-to-day management decisions. Weil met with prospective buyers and sellers of properties; assisted in negotiating partnership loans with its various lenders; and took an active role in dealing with personnel problems. Things continued to deteriorate for Sterling, and the partners began blaming each other for the partnership's problems.

Finally, Smith could no longer deal with the situation, and withdrew from the partnership. Edwards reminded Smith that the Sterling partnership agreement specifically prohibited withdrawal by a general partner without the consent of all the other partners. Smith advised Edwards and Weil that she would take no part in any further partnership undertaking and would not be responsible for partnership debts incurred after this withdrawal.

With Sterling on the verge of collapse, the following situations have occurred:

- Weil demanded the right to inspect and copy the partnership's books and records and Edwards refused to allow Weil to do so, claiming that Weil's status as a limited partner precludes that right.
- Anchor Bank, which made a loan to the partnership prior to Smith's withdrawal, is suing Sterling and each partner individually, including Smith, because the loan is in default. Weil denied any liability based on his limited partner status. Smith denies liability based on her withdrawal.
- Edwards sued Smith for withdrawing from the partnership and is uncertain about the effect of her withdrawal on the partnership.
- Weil wants to assign his partnership interest to Fred Alberts, who wants to become a substitute limited partner. Weil is uncertain about his right to assign this interest to Alberts and, further, the right of Alberts to become a substitute limited partner. Edwards contends that Edwards' consent is necessary for the assignment or the substitution of Alberts as a limited partner and that without this consent any such assignment would cause a dissolution of the partnership. The Sterling partnership agreement and certificate are silent in this regard.

Required:

Answer the following questions, setting forth reasons for the conclusions stated.

a. Is Weil entitled to inspect and copy the books and records of the partnership?

b. Are Weil and/or Smith liable to Anchor Bank?

c. Will Edwards prevail in the lawsuit against Smith for withdrawing from the partnership?

d. What is the legal implication to the partnership of Smith's withdrawal?

e. Can Weil assign his partnership interest to Alberts?

f. Can Edwards prevent the assignment to Alberts or the substitution of Alberts as a limited partner?
Business Law

g. What rights does Alberts have as assignee of Weil’s partnership interest?

h. What effect does an assignment have on the partnership?

N88
Number 4 (Estimated time — — 15 to 20 minutes)

On January 5, Stein, Rey, and Lusk entered into a written general partnership agreement by which they agreed to operate a stock brokerage firm. The agreement stated that the partnership would continue upon the death or withdrawal of a partner. The agreement also provided that no partner could reduce the firm’s commission below 2% without the consent of all of the other partners. On March 10, Rey, without the consent of Stein and Lusk, agreed with King Corp. to reduce the commission to 1½% on a large transaction by King. Rey believed this would entice King to become a regular customer of the firm. King was unaware of any of the terms of the partnership agreement.

On May 15, Stein entered into a contract conveying Stein’s partnership interest to Park and withdrew from the partnership. That same day, all of the partners agreed to admit Park as a general partner. Notice of Stein’s withdrawal and Park’s admission as a partner was properly published in two newspapers. In addition, third parties who had conducted business with the partnership prior to May 15 received written notice of Stein’s withdrawal.

Required:
a. In separate paragraphs, discuss whether:
   1. The partnership could recover the ½% commission from King.
   2. The partnership could recover the ½% commission from Rey.

b. In separate paragraphs, discuss:
   1. Park’s liability for partnership obligations arising both before and after being admitted to the partnership.
   2. Stein’s liability for partnership obligations arising both before and after withdrawing from the partnership.

N88
Number 3 (Estimated time — — 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

• The right to transfer a limited partnership interest versus shares of stock.

The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.

• The right of a limited partner versus that of a shareholder to participate in daily management.

• The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

C. Corporations

N89
Number 5 (Estimated time — — 15 to 20 minutes)

On May 12, 1987, West purchased 6% of Ace Corp.’s outstanding $3 cumulative preferred stock and 7% of Ace’s outstanding common stock. These are the only two classes of stock authorized by Ace’s charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace’s books and records to determine Ace’s financial condition. Ace has refused to permit West to examine its books and records.

On May 8, 1989, West lost the stock certificate representing the shares of preferred stock. On May 9, 1989, West notified Ace of the lost stock certificate and requested that Ace issue a new stock certificate. West offered to file an indemnity bond with Ace and to fulfill any reasonable requests made by Ace. Although Ace has no knowledge that any other party has acquired the lost stock certificate, Ace refused to issue a new stock certificate or accept the indemnity bond.

As a result of the foregoing, West has made the following assertions:

• Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.

• West is entitled to examine Ace’s books and records.

• West is entitled to receive a new stock certificate to replace the lost stock certificate.

Required: In separate paragraphs, discuss West’s assertions. Indicate whether such assertions are correct and the reasons therefor. Do not consider securities laws.
Selected Questions

M89
Number 4 (Estimated time — 15 to 20 minutes)

On May 1, 1987, Cray's board of directors unanimously voted to have Cray reacquire 100,000 shares of its common stock. On May 25, 1987, Cray did so, paying current market price. In determining whether to reacquire the shares, the board of directors relied on reports and financial statements that were negligently prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants. The reports and financial statements indicated that, as of April 30, 1987, Cray was solvent and there were sufficient funds to reacquire the shares. Subsequently, it was discovered that Cray had become insolvent in March 1987 and continued to be insolvent after the reacquisition of the shares. As a result of the foregoing, Cray experienced liquidity problems and losses during 1987 and 1988.

The board of directors immediately fired the treasurer because of the treasurer's negligence in supervising the preparation of the reports and financial statements. The treasurer had three years remaining on a binding five-year employment agreement which, among other things, prohibited the termination of the treasurer's employment for mere negligence.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- It was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent.
- The members of the board of directors are personally liable because they voted to reacquire shares while Cray was insolvent.
- Cray will be liable to the treasurer as a result of his termination by the board of directors.

M88
Number 3 (Estimated time — 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.
- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)
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, 50¢ par value, at $15 per share. The total number of authorized shares was fixed at 100,000 shares.
- Costs to organize Creme were $15,000.
- During 1982, Creme's board of directors declared and distributed a 5% common stock dividend. The fair market value of the stock at that time was $20 per share.
- On June 1, 1983, the president of Creme exercised a stock option to purchase 1,000 shares of common stock at $21 per share when the market price was $25 per share.
- During 1984, Creme's board of directors declared and distributed a 2-for-1 stock split on its common stock when the market price was $28 per share.
- During 1985, Creme acquired as treasury stock 5,000 shares of its common stock at a market price of $30 per share. Creme uses the cost method of accounting and reporting for treasury stock.
- During 1986, Creme reissued 3,000 shares of the treasury stock at the market price of $32 per share.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss what effect each of the transactions described above would have on stated capital (legal capital), indicating the dollar amount of change.

b. Discuss the requirements necessary to properly declare and pay cash dividends.

D. Estates and Trusts

Number 2 (Estimated time — — 15 to 20 minutes)

On May 1, 1988, Mary Stein sold a commercial building to Sam Bean and Bean's son, Bob, as equal tenants in common. At the time of the sale, there was a recorded existing mortgage on the building in favor of Fale Bank. The mortgage and the note it secured were silent as to whether the entire amount outstanding on the loan would become due upon the sale of the building. Sam and Bob did not assume the mortgage and it was not paid off when they purchased the building.

On June 15, 1989, Sam died leaving a will naming his wife, Rita Bean, as the beneficiary of his entire estate, except for certain stocks which were to be transferred to a spendthrift trust created for the benefit of Bob. The will named Rita as the trustee and Bob as the sole beneficiary of the trust. The provision in the will creating the spendthrift trust stated in part that:

Payments and distributions to the beneficiary shall be made only to the beneficiary in person or upon his personal receipt, and no interest of the beneficiary in the income or principal of the trust estate shall be assignable in anticipation of payment, either by the voluntary or involuntary act of the beneficiary or by operation of law, or be liable in any way for the debts of the beneficiary.

Required:

a. Discuss the personal liability of Sam Bean and Bob Bean, and the personal liability of Mary Stein, if there is a default on the mortgage to Fale and a foreclosure sale results in a deficiency.

b. Discuss the effect Sam Bean’s death will have on the ownership of the building.

c. Discuss the major purposes/benefits of a spendthrift trust such as the one created by Sam Bean.

d. Discuss whether
   1. A trust may generally be terminated by its beneficiaries; and
   2. The spendthrift trust created by Sam Bean could be terminated by Bob Bean.
Selected Questions

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.

III. Contracts

N90 Number 2 (Estimated time — 15 to 20 minutes)

The following letters were mailed among Jacobs, a real estate developer, Snow, the owner of an undeveloped parcel of land, and Eljay Distributors, Inc., a clothing wholesaler interested in acquiring Snow’s parcel to build a warehouse:

a. January 21, 1990 — Snow to Jacobs: “My vacant parcel (Lot 2, Birds Addition to Cedar Grove) is available for $125,000 cash; closing within 60 days. You must accept by January 31 if you are interested.”

This was received by Jacobs on January 31.

b. January 29, 1990 — Snow to Jacobs: “Ignore my January 21 letter to you; I have decided not to sell my lot at this time.”

This was received by Jacobs on February 3.


Jacobs inadvertently forgot to sign the January 31 letter, which was received by Snow on February 4.

d. February 2, 1990 — Jacobs to Eljay: “In consideration of your promise to pay me $10,000, I hereby assign to you my right to purchase Snow’s vacant lot (Lot 2, Birds Addition to Cedar Grove).”

This was received by Eljay on February 5.

All of the letters were signed, except as noted above, and properly stamped and addressed.

Snow has refused to sell the land to Jacobs or Eljay, asserting that no contract exists because:

- Jacobs’ acceptance was not received on a timely basis.

- Snow had revoked the January 21 offer.
- Jacobs’ acceptance was not signed.
- Jacobs had no right to assign the contract to Eljay.

Required: For each of Snow’s assertions, indicate whether the assertion is correct, setting forth reasons for your conclusion.

N90 Number 4 (Estimated time — 15 to 20 minutes)

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker’s financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for $9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp’s revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.

- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for $75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix’s offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker’s acceptance was received by Dix on December 20, 1988.
After reviewing the documents concerning the foregoing transactions, Best spoke with Anker's president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker's acceptance on December 12, 1988.
- Dix's letter dated December 12, 1988 formed an option contract with Anker.
- Anker's acceptance on December 19, 1988 formed a contract with Dix.

Required: In separate paragraphs, discuss the assertions made by Anker's president. Indicate whether the assertions are correct and the reasons therefor.

**M88**

**Number 2 (Estimated time — 15 to 20 minutes)**

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for $200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to $190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to $190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to $190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for $190,000. Birk refused to pay Starr $200,000 and a closing never occurred.

On October 30, 1987, a fire caused $80,000 damage to the warehouse at a time when its fair market value was $200,000. Starr had obtained a $160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for $40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000.
- Starr has an insurable interest in the warehouse covered under the policy with Pica.
- Starr has met the coinsurance requirement under Pica's policy.
- Starr is entitled to recover the entire $80,000 from Pica.

**Required:** Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

**M88**

**Number 5 (Estimated time — 15 to 20 minutes)**

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of $150,000 per month. The services were to have commenced on February 15, 1988 and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.
- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar $80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.
Selected Questions

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.

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.

IV. Debtor-Creditor Relationships

B. Bankruptcy

M80
Number 2 (Estimated time — — 15 to 20 minutes)

On February 1, 1990, Drake, a sole proprietor operating a retail clothing store, filed a bankruptcy petition under the liquidation provisions of the Bankruptcy Code. For at least six months prior to the filing of the petition, Drake had been unable to pay current business and personal obligations as they came due. Total liabilities substantially exceeded the total assets. A trustee was appointed who has converted all of Drake’s nonexempt property to cash in the amount of $96,000. Drake’s bankruptcy petition reflects a total of $310,000 of debts, including the following:

- A judgment against Drake in the amount of $19,500 as a result of an automobile accident caused by Drake’s negligence.
- Unpaid federal income taxes in the amount of $4,300 for the year 1983. (Drake filed an accurate tax return for 1983.)
- A $3,200 obligation payable on June 1, 1990, described as being owed to Martin Office Equipment, when, in fact, the debt is owed to Bartin Computer Supplies (Bartin has no knowledge of Drake’s bankruptcy and the time for filing claims has expired).
- Unpaid child support in the amount of $780 arising from a support order incorporated in Drake’s 1982 divorce judgment.

Prior to the filing of the petition, Drake entered into the following transactions:

- January 13, 1990 — paid Safe Bank $7,500, the full amount due on an unsecured loan given by Safe on November 13, 1989 (Drake had used the loan proceeds to purchase a family automobile).
- October 21, 1989 — conveyed to his brother, in repayment of a $2,000 debt, a painting that cost Drake $125 and which had a fair market value of $2,000.
- November 15, 1989 — borrowed $23,000 from Home Savings and Loan Association, giving Home a first mortgage on Drake’s residence, which has a fair market value of $100,000.
Business Law

- November 9, 1989 — paid $4,300 to Max Clothing Distributors for clothing delivered to Drake 60 days earlier (Drake had for several years purchased inventory from Max and his other suppliers on 60-day credit terms).

Required:

Answer the following questions, setting forth reasons for any conclusions stated.

a. Will the four debts described above be discharged in Drake’s bankruptcy?

b. What factors must the bankruptcy trustee show to set aside a transaction as a preferential transfer?

c. State whether each transaction entered into by Drake is a preferential or non-preferential transfer.

N89
Number 2 (Estimated time — — 15 to 20 minutes)

On March 23, 1989, Tine, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. The petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims of $3,000, $4,000, and $2,000, respectively. Tine also has 10 other unsecured creditors, three partially secured creditors, and two fully secured creditors, none of whom joined in the filing of the bankruptcy petition. For the six-month period before the filing of the bankruptcy petition, Tine had been unable to pay current obligations as they became due. At the time the petition was filed, Tine had a negative net worth.

Before March 23, 1989, Tine entered into the following transactions:

- On December 29, 1988, Tine borrowed $250,000 from Safe Finance. On January 31, 1989, after learning of Tine’s financial problems, Safe requested that Tine execute a mortgage on Tine’s residence naming Safe as mortgagee. On January 31, 1989, Tine executed the mortgage and delivered it to Safe and it was recorded that same day. The residence had a fair market value of $300,000 at all times.
- On May 5, 1988, Rich Bank loaned Tine $50,000 based on Tine’s personal financial statements. Tine knew the financial statements submitted to Rich substantially overstated Tine’s net worth because of misrepresentations that were difficult to detect.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the requirements necessary for the commencement of an involuntary bankruptcy proceeding were met.

b. Assuming that the requirements necessary for the commencement of an involuntary bankruptcy were met, discuss the following:

1. What action may the court take regarding the transactions between Tine and Safe?
2. What action may the court take regarding the transaction between Tine and Rich if Rich challenges the discharge of its debt?

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. Under the facts, were the requirements necessary for the filing of a valid petition in bankruptcy met? Discuss.

b. Discuss whether Lang’s actions in engaging Ring and including the inheritance in the bankruptcy estate were proper.

c. Indicate the order in which the $60,000 should be distributed to satisfy the claims and expenses of the bankruptcy estate, assuming all necessary court approvals have been obtained.
Selected Questions

V. Government Regulation of Business

A. Regulation of Employment

Number 3 (Estimated time — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

VI. Uniform Commercial Code

A. Commercial Paper

Number 3 (Estimated time — 15 to 20 minutes)

River Oaks is a wholesale distributor of automobile parts. River Oaks received the promissory note shown below from First Auto, Inc., as security for payment of a $4,400 auto parts shipment. When River Oaks accepted the note as collateral for the First Auto obligation, River Oaks was aware that the maker of the note, Hillcraft, Inc., was claiming that the note was unenforceable because Alexco Co. had breached the license agreement under which Hillcraft had given the note. First Auto had acquired the note from Smith in exchange for repairing several cars owned by Smith. At the time First Auto received the note, First Auto was unaware of the dispute between Hillcraft and Alexco. Also, Smith, who paid Alexco $3,500 for the note, was unaware of Hillcraft's allegations that Alexco had breached the license agreement.

PROMISSORY NOTE

Date: 1/14/90

Hillcraft, Inc. promises to pay to Alexco Co. or bearer the sum of $4,400
Four Thousand and 99/100 Dollars

on or before May 15, 1991 (maker may elect
to extend due date by 30 days) with interest thereon at the rate of 9 1/2% per annum.

Hillcraft, Inc.
By: P.J. Hill
P.J. Hill, President

Reference: Alexco Licensing Agreement
The reverse side of the note was endorsed as follows:

<table>
<thead>
<tr>
<th>Pay to the order of First Auto without recourse</th>
</tr>
</thead>
<tbody>
<tr>
<td>E. Smith ___________________________</td>
</tr>
<tr>
<td>E. Smith</td>
</tr>
<tr>
<td>Pay to the order of River Oaks Co.</td>
</tr>
<tr>
<td>First Auto</td>
</tr>
<tr>
<td>By: G. First</td>
</tr>
<tr>
<td>G. First, President</td>
</tr>
</tbody>
</table>

First Auto is now insolvent and unable to satisfy its obligation to River Oaks. Therefore, River Oaks has demanded that Hillcraft pay $4,400, but Hillcraft has refused, asserting:

- The note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand.
- River Oaks is not a holder in due course of the note because it received the note as security for amounts owed by First Auto.
- River Oaks is not a holder in due course because it was aware of the dispute between Hillcraft and Alexco.
- Hillcraft can raise the alleged breach by Alexco as a defense to payment.
- River Oaks has no right to the note because it was not endorsed by Alexco.
- The maximum amount that Hillcraft would owe under the note is $4,400, plus accrued interest.

Required:
State whether each of Hillcraft's assertions are correct and give the reasons for your conclusions.

M90
Number 5 (Estimated time — 15 to 20 minutes)

On February 12, 1990, Mayfair & Associates, CPAs, was engaged to audit the financial statements of University Book Distributors, Inc. University operates as a retail and wholesale distributor of books, newspapers, magazines, and other periodicals. In conjunction with the audit of University’s cash, notes, and accounts receivable, University’s controller gave Mayfair’s staff accountant certain instruments that University had received from its customers during 1989 in the ordinary course of its business. The instruments are:

- A signed promissory note dated June 30, 1989, in the amount of $3,100 payable “to Harris on December 31, 1989.” The maker of the note was Peters and it was indorsed in blank by Harris, who delivered it to University as payment for a shipment of magazines. University demanded that Peters pay the note but Peters refused, claiming that he gave the note as a result of misrepresentations by Harris related to a real estate transaction between the two of them. University advised Harris immediately of Peters’ refusal to pay.

- A signed promissory note dated July 31, 1989, in the amount of $1,800 payable “to the order of Able on January 15, 1990.” The maker of the note was Cole and it further provided that it was given “pursuant to that certain construction contract dated June 1, 1989.” The note had been given to University as payment for books by one of its customers, Baker, who did not indorse it. The note bears Able’s blank indorsement. University demanded payment from Cole. Cole refused to honor the note claiming that:

- The note’s reference to the construction contract renders it nonnegotiable; and
- University has no rights to the note because it was not indorsed by Baker.

University immediately advised Baker of Cole’s refusal to pay.
University is uncertain of its rights under the two notes.

Required:
Answer the following questions, setting forth reasons for your conclusions.

a. With regard to the note executed by Peters, is University a holder in due course?

b. Can Peters raise Harris’ alleged misrepresentations as a defense to University’s demand for payment?

c. Are Cole’s claims valid?

M87
Number 2 (Estimated time — 15 to 20 minutes)

Prince, Hall, & Charming, CPAs, has been retained to examine the financial statements of Hex Manufacturing Corporation. Shortly before beginning the examination for the year ended December 31, 1986, Mr. Prince received a telephone call from Hex’s president indicating that he thought some type of embezzlement was occurring because the corporation’s cash position was significantly lower than in prior years. The president then requested that Prince immediately undertake a special investigation to determine the amount of embezzlement, if any.

After a month of investigation, Prince uncovered an embezzlement scheme involving collusion between
the head of payroll and the assistant treasurer. The following is a summary of Prince's findings:

- The head of payroll supplied the assistant treasurer with punched time cards for fictitious employees. The assistant treasurer prepared invoices, receiving reports, and purchase orders for fictitious suppliers. The assistant treasurer prepared checks for the fictitious employees and suppliers which were signed by the treasurer. Then, either the assistant treasurer or the head of payroll would endorse the checks and deposit them in various banks where they maintained accounts in the names of the fictitious payees. All of the checks in question have cleared Omega Bank, the drawee.

- The embezzlement scheme had been operating for 10 months and more than $120,000 had been embezzled by the time the scheme was uncovered. The final series of defalcations included checks payable directly to the head of payroll and the assistant treasurer. These checks included skillful forgeries of the treasurer's signature that were almost impossible to detect. This occurred while the treasurer was on vacation. These checks have also cleared Omega Bank, the drawee.

**Required**: Answer the following, setting forth reasons for any conclusions stated.

Will Hex or Omega bear the loss with respect to the following categories of checks:

a. those which were signed by the treasurer but payable to fictitious payees?

b. those which include the forged signature of the treasurer?

**B. Documents of Title and Investment Securities**

**N89**

**Number 5 (Estimated time — 15 to 20 minutes)**

On May 12, 1987, West purchased 6% of Ace Corp.'s outstanding $3 cumulative preferred stock and 7% of Ace's outstanding common stock. These are the only two classes of stock authorized by Ace's charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace's books and records to determine Ace's financial condition. Ace has refused to permit West to examine its books and records.

On May 8, 1989, West lost the stock certificate representing the shares of preferred stock. On May 9, 1989, West notified Ace of the lost stock certificate and requested that Ace issue a new stock certificate. West offered to file an indemnity bond with Ace and to fulfill any reasonable requests made by Ace. Although Ace has no knowledge that any other party has acquired the lost stock certificate, Ace refused to issue a new stock certificate or accept the indemnity bond.

As a result of the foregoing, West has made the following assertions:

- Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.
- West is entitled to examine Ace's books and records.
- West is entitled to receive a new stock certificate to replace the lost stock certificate.

**Required**: In separate paragraphs, discuss West's assertions. Indicate whether such assertions are correct and the reasons therefor. Do not consider securities law.

**C. Sales**

**N80**

**Number 4 (Estimated time — 15 to 20 minutes)**

Pharo Aviation, Inc. sells and services used airplanes. Sanders, Pharo's service department manager, negotiated with Secure Equipment Co. for the purchase of a used tug for moving airplanes in and out of Pharo's hangar. Secure sells and services tugs and related equipment. Sanders was unfamiliar with the various models, specifications, and capacities of the tugs sold by Secure; however, Sanders knew that the tug purchased needed to have the capacity to move airplanes weighing up to 10,000 pounds. Sanders and the sales representative discussed this specific need because Sanders was uncertain as to which tug would meet Pharo's requirements. The sales representative then recommended a particular make and model of tug. Sanders agreed to rely on the sales representative's advice and signed a purchase contract with Secure.

About a week after Sanders took delivery, the following occurred:

- Sanders determined that the tug did not have the capacity to move airplanes weighing over 5,000 pounds.
- Sanders was advised correctly by Maco Equipment Distributors, Inc. that Maco was the rightful owner of the tug, which it had left with Secure for repairs.

Pharo has commenced a lawsuit against Secure claiming that implied warranties were created by the contract with Secure and that these have been breached. Maco has claimed that it is entitled to the tug and has demanded its return from Pharo.
Business Law

Required:
Answer each of the following questions, and set forth the reasons for your conclusions.

a. Were any implied warranties created by the contract between Pharao and Secure and, if so, were any of those warranties breached?

b. Is Maco entitled to the return of the tug?

N89
Number 4 (Estimated time — 15 to 20 minutes)

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker’s financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for $9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp’s revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.
- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for $75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix’s offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker’s acceptance was received by Dix on December 20, 1988.

After reviewing the documents concerning the foregoing transactions, Best spoke with Anker’s president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker’s acceptance on December 12, 1988.
- Dix’s letter dated December 12, 1988 formed an option contract with Anker.
- Anker’s acceptance on December 19, 1988 formed a contract with Dix.

Required: In separate paragraphs, discuss the assertions made by Anker’s president. Indicate whether the assertions are correct and the reasons therefor.

N89
Number 5 (Estimated time — 15 to 20 minutes)

On February 20, 1989, Pine, Inc. ordered a specially manufactured computer system consisting of a disk drive and a central processing unit (CPU) from Xeon Corp., a seller of computers and other office equipment. A contract was signed and the total purchase price was paid to Xeon by Pine on the same date. The contract required Pine to pick up the computer system at Xeon’s warehouse on March 9, 1989, but was silent as to when risk of loss passed to Pine. The computer system was completed on March 1, 1989, and set aside for Pine’s contemplated pickup on March 9, 1989. On March 3, 1989, the disk drive was stolen from Xeon’s warehouse. On March 9, 1989, Pine picked up the CPU. On March 15, 1989, Pine returned the CPU to Xeon for warranty repairs. On March 18, 1989, Xeon mistakenly sold the CPU to Meed, a buyer in the ordinary course of business.

On April 12, 1989, Pine purchased and received delivery of five word processors from Jensen Electronics Corp. for use in its business. The purchase price of the word processors was $15,000. Pine paid $5,000 down and executed an installment purchase note and a security agreement for the balance. The security agreement contained a description of the word processors. Jensen never filed a financing statement. On April 1, 1989, Pine had given its bank a security interest in all of its assets. The bank had immediately perfected its security interest by filing. Pine has defaulted on the installment purchase note.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- As of March 3, 1989, the risk of loss on the disk drive remained with Xeon.
- Meed acquired no rights in the CPU as a result of the March 18, 1989, transaction.
- Jensen’s security interest in the word processors never attached and therefore Jensen’s security interest is not enforceable against Pine.
- Jensen has a superior security interest to Pine’s bank.

N88
Number 3 (Estimated time — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This
Selected Questions

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.

M-88
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. Spear 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 delivered to Spear pursuant to the December 22 transaction with Spear?

Required: Discuss the issues raised by Mirk, setting forth your conclusions and reasons therefor.

M-87
Number 2 (Estimated time — — 15 to 20 minutes)

On May 1, Starr Corp., a manufacturer and supplier of computers, mailed a proposed contract to Magic, Inc., offering to sell 20 items of specified computer equipment for $18,000. Magic was engaged in the business of selling computers to the public. Magic accepted Starr’s offer by executing and returning the contract to Starr. Starr failed to sign the contract.

On May 15, Starr advised Magic by telephone that, due to certain market conditions, the price of computer parts had increased. Therefore, in order to avoid a loss on the sale to Magic, Starr requested an increase in the sales price to $20,000, which was orally agreed to by Magic. On May 17, Starr sent to Magic a signed letter acknowledging this agreement. Magic did not respond to the letter.
On September 15, Starr notified Magic that the equipment was ready for delivery. Due to substantial changes in computer technology subsequent to May 15, Magic indicated that it no longer wanted the equipment and that it would not pay for it. Starr was unable to resell the computer equipment for any price despite its reasonable efforts to do so. Therefore, Starr commenced a breach of contract action against Magic. Magic asserted the following defenses:

- The May 1 written contract between Starr and Magic is not enforceable because of the statute of frauds.
- Even if the May 1 contract is enforceable, the May 15 oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds.
- In any event, Starr is not entitled to recover the full sales price because the equipment is still in Starr's possession.

**Required:** Discuss Magic's assertions, indicating whether each is correct or incorrect and setting forth the reasons for any conclusions stated.

**D. Secured Transactions**

**N80**

**Number 5 (Estimated time — 15 to 20 minutes)**

Wizard Computer Co. sells computers to the general public. On April 30, Wizard financed the purchase of its computer inventory with National Bank. Wizard executed and delivered a promissory note and a security agreement covering the inventory. National filed a financing statement on the same day.

On May 1, Wizard sold a computer out of its inventory to Kast, who intended to use it to do some household budgeting. Kast made a 10% down payment toward the purchase price. Kast executed and delivered to Wizard a promissory note for the balance and a security agreement covering the computer. Kast was aware that Wizard financed its inventory with National. Wizard did not file a financing statement.

On May 6, Kast, who was dissatisfied with the computer, sold it on credit to Marc, who intended to use it to assist in family budgeting. Marc, who was unaware that Kast had purchased the computer on credit, paid 25% of the purchase price and executed and delivered to Kast a promissory note for the balance and a security agreement covering the computer. Kast did not file a financing statement.

On May 12, Marc borrowed $6,000 from Alcor Finance. Marc gave Alcor a promissory note for the loan amount and a security agreement covering the computers and other household appliances owned by Marc. Alcor did not file a financing statement.

Marc failed to pay Alcor or Kast. In turn, Kast has been unable to pay Wizard. On June 2, Wizard defaulted on its obligation to National.

Kast and Marc take the following positions:

- Kast asserts that the computer was purchased from Wizard free of National's security interest.
- Marc asserts that the computer was purchased from Kast free of Wizard's security interest.
- Marc asserts that Alcor's security interest is unenforceable against Marc because Alcor failed to file a financing statement.

**Required:**

For each assertion, indicate whether it is correct, and set forth the reasons for your conclusion.

**M88**

**Number 4 (Estimated time — 15 to 20 minutes)**

Dunn & Co., CPAs, is auditing the 1987 financial statements of its client, Safe Finance. While performing the audit, Dunn learned of certain transactions that occurred during 1987 that may have an adverse impact on Safe's financial statements. The following transactions are of most concern to Dunn:

- On May 5, Safe sold certain equipment to Lux, who contemporaneously executed and delivered to Safe a promissory note and security agreement covering the equipment. Lux purchased the equipment for use in its business. On May 8, City Bank loaned Lux $50,000, taking a promissory note and security agreement from Lux that covered all of Lux's existing and after-acquired equipment. On May 11, Lux was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee was appointed. On May 12, City filed a financing statement covering all of Lux's equipment. On May 14, Safe filed a financing statement covering the equipment it had sold to Lux on May 5.

- On July 10, Safe loaned $600,000 to Cam Corp., which used the funds to refinance existing debts. Cam duly executed and delivered to Safe a promissory note and a security agreement covering Cam's existing and after-acquired inventory of machine parts. On July 12, Safe filed a financing statement covering Cam's inventory of machine parts. On July 15, Best Bank loaned Cam $200,000. Contemporaneous with the loan, Cam executed and delivered to Best a promissory note and security agreement covering all of Cam's inventory of machine parts and any after-acquired inventory. Best had already filed a financing statement covering Cam's inventory on June 20, after Best agreed to make the loan to Cam. On July 14, Dix, in good faith, purchased certain machine parts from Cam's inventory and received delivery that same day.

**Required:** Define a purchase money security interest. In separate paragraphs, discuss whether Safe has a priority security interest over:
Selected Questions

- The trustee in Lux’s bankruptcy with regard to the equipment sold by Safe on May 5.
- City with regard to the equipment sold by Safe on May 5.
- Best with regard to Cam’s existing and after-acquired inventory of machine parts.
- Dix with regard to the machine parts purchased on July 14 by Dix.

VII. Property

A. Real and Personal Property

M89
Number 2 (Estimated time — 15 to 20 minutes)

On May 1, 1988, Mary Stein sold a commercial building to Sam Bean and Bean’s son, Bob, as equal tenants in common. At the time of the sale, there was a recorded existing mortgage on the building in favor of Fale Bank. The mortgage and the note it secured were silent as to whether the entire amount outstanding on the loan would become due upon the sale of the building. Sam and Bob did not assume the mortgage and it was not paid off when they purchased the building.

On June 15, 1989, Sam died leaving a will naming his wife, Rita Bean, as the beneficiary of his entire estate, except for certain stocks which were to be transferred to a spendthrift trust created for the benefit of Bob. The will named Rita as the trustee and Bob as the sole beneficiary of the trust. The provision in the will creating the spendthrift trust stated in part that:

Payments and distributions to the beneficiary shall be made only to the beneficiary in person or upon his personal receipt, and no interest of the beneficiary in the income or principal of the trust estate shall be assignable in anticipation of payment, either by the voluntary or involuntary act of the beneficiary or by operation of law, or be liable in any way for the debts of the beneficiary.

Required:
- a. Discuss the personal liability of Sam Bean and Bob Bean, and the personal liability of Mary Stein, if there is a default on the mortgage to Fale and a foreclosure sale results in a deficiency.
- b. Discuss the effect Sam Bean’s death will have on the ownership of the building.
- c. Discuss the major purposes/benefits of a spendthrift trust such as the one created by Sam Bean.
- d. Discuss whether
  1. A trust may generally be terminated by its beneficiaries; and

M89
Number 3 (Estimated time — 15 to 20 minutes)

On March 2, 1988, Ash, Bale, and Rangel purchased an office building from Park Corp. as joint tenants with right of survivorship. There was an outstanding note and mortgage on the building, which they assumed. The note and mortgage named Park as the mortgagor (borrower) and Vista Bank as the mortgagee (lender). Vista has consented to the assumption.

Wein, Inc., a tenant in the office building, had entered into a 10-year lease dated May 8, 1985. The lease was silent regarding Wein’s right to sublet. The lease provided for Wein to take occupancy on June 1, 1985, and that the monthly rent would be $5,000 for the entire 10-year term. On March 10, 1989, Wein informed Ash, Bale, and Rangel that it had agreed to sublet its office space to Nord Corp. On March 17, 1989, Ash, Bale, and Rangel notified Wein of their refusal to consent to the sublet. The following assertions have been made:

- The sublet from Wein to Nord is void because Ash, Bale, and Rangel did not consent.
- If the sublet is not void, Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of the rent.

On April 4, 1989, Ash transferred his interest in the building to his spouse.

Required: Answer the following, setting forth reasons for any conclusions stated.
- a. For this item only, assume that Ash, Bale, and Rangel default on the mortgage note, that Vista forecloses, and a deficiency results. Discuss the personal liability of Ash, Bale, and Rangel to Vista and the personal liability of Park to Vista.
- b. Discuss the assertions as to the sublet, indicating whether such assertions are correct and the reasons therefor.
- c. For this item only, assume that Ash and Rangel died on April 20, 1989. Discuss the ownership interest(s) in the office building as of April 5, 1989, and April 21, 1989.
B. Mortgages

M91 Number 4 (Estimated time — 15 to 20 minutes)

On February 1, 1988, Tower and Perry, as tenants in common, purchased a two-unit apartment building for $250,000. They made a down payment of $100,000, and gave a $100,000 first mortgage to Midway Bank and a $50,000 second mortgage to New Bank.

New was aware of Midway's mortgage but, as a result of a clerical error, Midway did not record its mortgage until after New's mortgage was recorded.

At the time of purchase, a $200,000 fire insurance policy was issued by Acme Insurance Co. to Tower and Perry. The policy contained an 80% coinsurance clause and a standard mortgage provision.

Tower and Perry rented an apartment to Young under a month-to-month oral lease. They rented the other apartment to Zimmer under a three-year written lease.

On December 8, 1989, Perry died leaving a will naming the Dodd Foundation as the sole beneficiary of Perry's estate. The estate was distributed on January 15, 1990. That same date, the ownership of the fire insurance policy was assigned to Tower and Dodd with Acme's consent. On January 21, 1990, a fire caused $180,000 in structural damage to the building. At that time, its market value was $300,000 and the Midway mortgage balance was $80,000 including accrued interest. The New mortgage balance was $40,000 including accrued interest.

The fire made Young's apartment uninhabitable and caused extensive damage to the kitchen, bathrooms, and one bedroom of Zimmer's apartment. On February 1, 1990, Young and Zimmer moved out. The resulting loss of income caused a default on both mortgages.

On April 1, 1990, Acme refused to pay the fire loss claiming that the required insurable interest did not exist at the time of the loss and that the amount of the insurance was insufficient to provide full coverage for the loss. Tower and Dodd are involved in a lawsuit contesting the ownership of the building and the claims they have both made for any fire insurance proceeds.

On June 1, 1990, Midway and New foreclosed their mortgages and are also claiming any fire insurance proceeds that may be paid by Acme.

On July 1, 1990, Tower sued Zimmer for breach of the lease and is seeking to collect the balance of the lease term rent.

The above events took place in a notice-race statute jurisdiction.

Required:
Answer the following questions and give the reasons for your conclusions.

a. Who had title to the building on January 21, 1990?

b. Did Tower and/or Dodd have an insurable interest in the building when the fire occurred? If so, when would such an interest have arisen?

c. Does Acme have to pay under the terms of the fire insurance policy? If so, how much?

d. Assuming the fire insurance proceeds will be paid, what would be the order of payment to the various parties and in what amounts?

e. Would Tower succeed in the suit against Zimmer?

C. Fire and Casualty Insurance

N88 Number 2 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for $200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to $190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to $190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to $190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for $190,000. Birk refused to pay Starr $200,000 and a closing never occurred.

On October 30, 1987, a fire caused $80,000 damage to the warehouse at a time when its fair market value was $200,000. Starr had obtained a $160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for $40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000.
- Starr has an insurable interest in the warehouse covered under the policy with Pica.
Selected Questions

- Starr has met the coinsurance requirement under Pica's policy.
- Starr is entitled to recover the entire $80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.
I. The CPA and the Law

**M91 Answer 5 (10 points)**

a. Knox would recover from Garson for fraud. The elements of fraud are: the misrepresentation of a material fact (because Garson issued an unqualified opinion on misleading financial statements. Garson’s opinion did not include adjustments for or disclosures about the embezzlements and insider stock transactions); with knowledge or scienter (because Garson was aware of the embezzlements and insider stock transactions); and a loss sustained by Knox (because of Sleek’s default on the loan).

b. 1. The general public purchasers of Sleek’s stock offerings would recover from Garson under the liability provisions of Section 11 of the Securities Act of 1933. Section 11 of the Act provides that anyone, such as an accountant, who submits or contributes to a registration statement or allows material misrepresentations or omissions to appear in a registration statement is liable to anyone purchasing the security who sustains a loss. Under the facts presented, Garson could not establish a “due diligence” defense to a Section 11 action because it knew that the registration statement failed to disclose material facts.

b. 2. The general public purchasers of Sleek’s stock offerings would also recover from Garson under the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under Rule 10b-5, Garson’s knowledge that the registration statement failed to disclose a material fact, such as the insider trading and the embezzlements, is considered a fraudulent action. The omission was material. Garson’s action was intentional or, at a minimum, a result of gross negligence or recklessness (scienter). These purchasers relied on Garson’s opinion on the financial statements and incurred a loss.

c. The elements necessary to establish a violation of Rule 10b-5 include:

- A material misstatement or omission.
- The material misstatement or omission made by the defendant (Apple) with knowledge (scienter). Reckless disregard for the truth may constitute scienter.
- Justifiable reliance on the misstatement or omission.
- The reliance being in connection with the purchase or sale of a security.

d. Apple is not in privity of contract with Musk because there is no direct contractual relationship between them. Therefore, in the absence of other factors, Apple would not be liable to Musk for Apple’s alleged negligence based on the *Ultramares* decision. However, the privity defense would not protect Apple if Musk could prove that Apple had committed actual or constructive fraud (that is, Apple owes a duty to all persons, including third persons, to practice its profession in a non-fraudulent manner).

**M90 Answer 3 (10 points)**

a. Yes. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute creating such a privilege, Apple will be required to produce its working papers. Furthermore, the right to assert the accountant-client privilege, when applicable, generally rests with the client and not with the accountant.

b. The elements necessary to establish negligence are:

- A legal duty to protect the plaintiff (Musk) from unreasonable risk.
- A failure by the defendant (Apple) to perform or report on an engagement with the due care or competence expected of members of its profession.
- A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff’s loss.
- Actual damage or loss resulting from the failure to exercise due care.

c. The elements necessary to establish a violation of Rule 10b-5 include:

- A material misstatement or omission.
- The material misstatement or omission made by the defendant (Apple) with knowledge (scienter). Reckless disregard for the truth may constitute scienter.
- Justifiable reliance on the misstatement or omission.
- The reliance being in connection with the purchase or sale of a security.

d. Apple is not in privity of contract with Musk because there is no direct contractual relationship between them. Therefore, in the absence of other factors, Apple would not be liable to Musk for Apple’s alleged negligence based on the *Ultramares* decision. However, the privity defense would not protect Apple if Musk could prove that Apple had committed actual or constructive fraud (that is, Apple owes a duty to all persons, including third persons, to practice its profession in a non-fraudulent manner).

**City is likely to prevail against Salam based on constructive fraud. To establish a cause of action for constructive fraud, City must prove that:**

- Salam made a materially false statement of fact.
- Salam lacked a reasonable ground for belief that the statement was true. Constructive fraud may be inferred from evidence of gross negligence or recklessness.
- Salam intended another to rely on the false statement.
Business Law

- City justifiably relied on the false statement.
- Such reliance resulted in damages or injury.

Under the facts of this case, Salam is likely to be liable to City based on constructive fraud. Salam made a materially false statement of fact by rendering an unqualified opinion on Bell's financial statements. Salam lacked a reasonable ground for belief that the financial statements were fairly presented by recklessly departing from the standards of due care in that it failed to investigate other embezzlements, despite having knowledge of at least one embezzlement, and did not notify Bell of the management of the matter. Salam intended that others rely on the audited financial statements. City justifiably relied on the audited financial statements in deciding to loan Astor $600,000 and damages resulted evidenced by Astor's default on the City loan.

City is not likely to prevail against Salam based on negligence. In order to establish a cause of action for negligence against Salam, City must prove that:

- Salam owed a legal duty to protect City.
- Salam breached that duty by failing to perform the audit with the due care or competence expected of members of the profession.
- City suffered actual losses or damages.
- Salam's failure to exercise due care proximately caused City to suffer damages.

The facts of this case establish that Salam was negligent by not detecting the overstatement of accounts receivable because of its inadvertent failure to follow its audit program. However, Salam will not be liable to City for negligence because Salam owed no duty to City. This is the case because Salam was not in privity of contract with City, and the financial statements were neither audited by Salam for the primary benefit of City, nor was City within a known and intended class of third party beneficiaries who were to receive the audited financial statements.

N88

Answer 5 (10 points)

Crea will not be liable to the purchasers of the common stock. Although an offering of securities made pursuant to Regulation D is exempt from the registration requirements of the Securities Act of 1933, the antifraud provisions of the federal securities acts continue to apply. In order to establish a cause of action under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, the purchasers generally must show that: Crea made a material misrepresentation or omission in connection with the purchase or sale of a security; Crea acted with some element of scienter (intentional or willful conduct); Crea's wrongful conduct was material; the purchasers relied on Crea's wrongful conduct; and, that there was a sufficient causal connection between the purchasers' loss and Crea's wrongful conduct.

Under the facts of this case, Crea's inadvertent failure to exercise due care, which resulted in Crea's not detecting the president's embezzlement, will not be sufficient to satisfy the scienter element because such conduct amounts merely to negligence. Therefore, Crea will not be liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

Crea is likely to be held liable to Safe Bank based on Crea's negligence despite the fact that Safe is not in privity of contract with Crea. In general, a CPA will not be liable for negligence to creditors if its auditor's report was primarily for the benefit of the client, for use in the development of the client's business, and only incidentally or collaterally for the use of those to whom the client might show the financial statements. However, a CPA is generally liable for ordinary negligence to third parties if the audit report is for the identified third party's primary benefit.

In order to establish Crea's negligence, Safe must show that: Crea had a legal duty to protect Safe from unreasonable risk; Crea failed to perform the audit with the due care or competence expected of members of its profession; there was a causal relationship between Safe's loss and Crea's failure to exercise due care; actual damage or loss resulting from Crea's failure to exercise due care. On the facts of this case, Crea will be liable based on negligence since the audited financial statement reports were for the primary benefit of Safe, an identified third party, and Crea failed to exercise due care in detecting the president's embezzlement, which resulted in Safe's loss, i.e., Dark's default in repaying the loan to Safe.

N88

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
Unofficial Answers

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 standards 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.

II. Business Organizations

A. Agency

N80
Answer 3 (10 points)

a. Peterson was acting for an undisclosed principal (Prime) with regard to the contract with Hallow. Peterson was acting with actual authority; therefore, Prime is liable to Hallow. Peterson is also liable to Hallow because agents acting on behalf of undisclosed principals are liable to the third parties on the contracts they enter into with such third parties on behalf of the principal. Hallow, however, cannot collect damages from both Peterson and Prime and must make an election between them.

b. At the time of the accident, Peterson was acting within the scope of employment because the conduct engaged in (that is, entering into a contract with Hallow) was authorized by Prime. Prime, therefore, will be liable to Mathews because the accident occurred within the scope of Peterson’s employment. Peterson will also be liable to Mathews because all persons are liable for their own negligence.

e. Peterson’s actual authority to enter into contracts on Prime’s behalf ceased on termination of employment.

B-93
by Prime. Peterson, however, continued to have apparent authority to bind Prime because:

- Peterson was acting ostensibly within the scope of authority as evidenced by past transactions with Bagley;
- Bagley was unaware of Peterson's termination.

The trade journal announcement was not effective notice to terminate Peterson's apparent authority in relation to Bagley because:

- Prime was obligated to give actual notice to Bagley that Peterson was no longer employed;
- Actual notice is required because of Bagley's past contact with Peterson while Peterson was employed by Prime.

 override

**B. Partnerships and Joint Ventures**

**M91**

**Answer 2 (10 points)**

1. Mathews' first position is incorrect. A partner is considered an agent of the partnership in carrying out its usual business. In this case, Baker lacked actual authority to bind Prime to the Jaco contract; however, Baker did have, from Jaco's perspective, apparent authority to do so because of the general character of Prime's business and, more important, because Baker had previously purchased cars from Jaco on Prime's behalf. Jaco was not bound by the limitation on Baker's authority unless Jaco was aware of it.

2. Mathews' second position is also incorrect. As a general rule, a partner is liable for the debts of the partnership, and a third party is not bound by the profit and loss sharing agreements between partners because the third party is not a party to the partnership agreement. Therefore, Jaco can look to Prime's assets and Mathews' personal assets to satisfy the obligation.

3. Mathews' third position is correct. A partner is liable to other partners for any liability associated with contracts entered into ostensibly on behalf of the partnership but outside the partner's actual authority. In this case, because Baker violated the agreement with Mathews concerning the $15,000 limitation on used car purchases, Baker will be liable to Mathews for any liability that Mathews may have to Jaco.

4. Mathews' fourth position is also correct. A partner owes a fiduciary duty (that is, a duty of loyalty) to the partnership and every other partner. A partner may not benefit directly or indirectly at the expense of the partnership. A partner must account to the partnership for any benefits derived from the partnership's business without the consent or knowledge of the other partners. In this case, Baker was not entitled to accept and retain the incentive payments made by Top. Doing so violated Baker's fiduciary duty to Prime and Mathews. Baker must account to Prime for all the incentive payments received.

**M90**

**Answer 4 (10 points)**

a. Weil is entitled to inspect and copy Sterling's books and records. A limited partner such as Weil has the right to have the partnership books kept at the principal place of business of the partnership and to inspect and copy them at all times.

b. Generally, limited partners are not liable to partnership creditors except to the extent of their capital contribution. In Weil's case, however, he will probably be liable to Anchor Bank in the same manner as Sterling's general partners because he has taken part in the control of the business of the partnership and, therefore, has lost his limited liability. Smith, as a general partner, would also be personally liable to Anchor because liability was incurred prior to withdrawal.

c. Edwards will likely prevail in his lawsuit against Smith for withdrawing because the partnership agreement specifically prohibits a withdrawal by a general partner without the consent of the other partners. Therefore, Smith has breached the partnership agreement and will be liable to Edwards for any damages resulting from Smith's withdrawal.

d. The withdrawal (retirement) of a general partner dissolves the partnership unless the remaining general partners continue the business of the partnership under a right to do so provided in the limited partnership certificate, or unless all partners consent. Therefore, it is possible that Smith's withdrawal will result in Sterling's dissolution.

e. Weil is free to assign his limited partnership interests to Alberts in the absence of any prohibitions in the Sterling partnership agreement or certificate.

f. Alberts, however, cannot be a substitute limited partner without the consent of the remaining general partner, Edwards.

g. Therefore, Alberts, as an assignee of Weil's limited partnership interest, may not exercise any rights of a partner. Alberts is entitled only to any distributions from Sterling to which Weil would have been entitled.

h. Finally, the assignment by Weil of his partnership interest does not cause a dissolution of the partnership.
Unofficial Answers

B-95

M88

Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state's limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation's organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner's liability for partnership debts is generally limited to the partner's investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder's liability for a corporation's debts is generally limited to the shareholder's investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership's business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation's business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership's profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

C. Corporations

M88

Answer 5 (10 points)

West's assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation. Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not
declared by Ace's board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West's assertion that West is entitled to examine Ace's books and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

West's assertion that West is entitled to receive a new stock certificate to replace the lost stock certificate is correct. Because the subject matter in this case is a stock certificate of a corporation, the UCC Investment Securities Article applies. Under that article, the stock certificate of Ace is classified as a certificate of security because it is one of a class of Ace's shares that is represented by an instrument in West's name and is traded on a national securities exchange. If the owner of a certificate of security claims that the security has been lost, the issuer shall issue a new certificate of security, or, at the option of the issuer, an equivalent uncertificated security in place of the original security if the owner makes a request before the issuer has notice that the security has been acquired by a bona fide purchaser, files a sufficient indemnity bond with the issuer, and satisfies any other reasonable requirements imposed by the issuer. Based on the facts of this case, West is entitled to receive a new stock certificate because West requested that a new stock certificate be issued before Ace had notice the lost certificate was acquired by any other party, offered to file an indemnity bond with Ace, and offered to cooperate with any reasonable requests made by Ace.

M89
Answer 4 (10 points)

The assertion that it was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent is correct. A board of directors may authorize and the corporation may reacquire its shares of stock subject to any restriction in the articles of incorporation, except that no reacquisition may be made if, after giving effect thereto, either the corporation would be unable to pay its debts as they become due in the usual course of business or the corporation's total assets would be less than its total liabilities. Because Cray was insolvent before and after the reacquisition of Cray's common stock, it was improper for the board of directors to authorize the reacquisition.

The assertion that the members of Cray's board of directors are personally liable because Cray reacquired its own shares of Cray stock while Cray was insolvent is incorrect. In general, directors who vote or assent to a reacquisition by the corporation of its own shares while the corporation is insolvent will be jointly and severally liable to the corporation. However, the directors will not be liable if they acted in good faith, in a manner they reasonably believed to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing their duties, directors are entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by one or more officers or employees of the corporation whom the directors reasonably believe to be reliable and competent in the matters presented. The directors may rely on the same information prepared or presented by independent accountants that the directors reasonably believe to be within such person's professional competence. Based on the facts of this case, the directors' reliance on the reports and financial statements prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants was proper so long as the directors exercised due care, acted in good faith, and acted without knowledge that would cause such reliance to be unwarranted. In addition, the courts are precluded from substituting their business judgment for that of the board of directors if the directors have acted with due care and in good faith.

The assertion that Cray will be liable to the treasurer as a result of his termination by the board of directors is correct. An officer may be removed by the board of directors with or without cause whenever in its judgment the best interests of the corporation will be served by the removal. However, such removal is without prejudice to the contract rights of the person so removed. Thus, the board of directors had the power to remove the treasurer. The treasurer will prevail in a breach of contract action for damages against Cray because the firing violated the employment agreement.

N88
Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish
Unofficial Answers

M67 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 × 50¢ 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 × 50¢ 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 × 50¢ 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.

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 prohibits dividend distributions if, after giving effect to the distribution, the corporation’s total assets would be less than its total liabilities.
D. Estates and Trusts

N89
Answer 2 (10 points)

a. Sam Bean and Bob Bean will not be personally liable to Fale for the deficiency resulting from the foreclosure sale because they did not assume the mortgage but instead purchased the building subject to the mortgage. In the absence of a state statute to the contrary, Stein will be personally liable for the deficiency because Stein was not released from liability on the note and mortgage.

b. There is no right of survivorship feature in a tenancy in common and, therefore, Rita Bean will acquire Sam Bean’s one-half interest in the building under her husband’s will. Thus, Rita Bean will own a one-half interest in the building as a tenant in common with Bob Bean.

c. In general, the purposes and benefits of creating a spendthrift trust are to provide a fund for the maintenance of another (the beneficiary); protect the fund from the beneficiary’s financial mismanagement and improvidence; prohibit the beneficiary from transferring the right to future trust income or principal; and prohibit the beneficiary’s interest from being subjected to the claims of the beneficiary’s creditors.

d.1. A trust may generally be terminated by the beneficiaries if all consent to the termination; all are legally competent to consent; and termination will not defeat a material purpose for which the trust was created.

2. The spendthrift trust created by Sam Bean cannot be terminated by Bob Bean because the major purpose of a spendthrift trust is to protect the beneficiary from mismanagement and improvidence. Thus, termination of the spendthrift trust would defeat the purpose for which it was created.

III. Contracts

N90
Answer 2 (10 points)

Snow’s assertion that Jacobs’ acceptance was not received on a timely basis is incorrect. Jacobs’ January 31 acceptance was effective when dispatched (mailed) under the complete-when-posted doctrine because:

- The letter was an authorized means of communication (because Snow’s offer was by mail); and
- The letter was properly stamped and addressed.

Therefore, Jacobs’ acceptance was effective on January 31, the last possible day under Snow’s January 21 offer.

Snow’s assertion that the January 21 offer was effectively revoked is incorrect because a revocation is not effective until received. In this case, the revocation was effective on February 3, and Jacobs’ acceptance was effective on January 31.

Snow’s assertion that Jacobs’ failure to sign the January 31 acceptance prevents the formation of a con-
contract is incorrect. The Statute of Frauds, which applies to contracts involving interests in real estate, requires only the signature of the party to be charged with enforcement of the contract. Therefore, because Snow had signed the January 21 offer, which was accepted by Jacobs, the contract is enforceable against Snow.

Snow's assertion that Jacobs had no right to assign the contract is incorrect. Contract rights, including the right to purchase real estate, are generally assignable unless the assignment:

- Would materially increase the risk or burden of the obligor;
- Purports to transfer highly personal contract rights;
- Is validly prohibited by the contract; or
- Is prohibited by law.

None of these limitations applies to the assignment by Jacobs to Eljay.

N89

Answer 4 (10 points)

The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that DIX's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.

N88

Answer 2 (10 points)

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to $190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for $200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay $200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire $80,000 from Pica is incorrect.
Business Law

is only entitled to receive $64,000 from Pica calculated as follows:

\[
\frac{$160,000 \text{ (Amount of Insurance Coverage with Pica)}}{$200,000 \text{ (Total Amount of Insurance on Warehouse)}} \times $80,000 \text{ (Amount to be Paid)} = $64,000
\]

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

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 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 offeree 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.
Unofficial Answers

IV. Debtor-Creditor Relationships

B. Bankruptcy

M90

Answer 2 (10 points)

a. The judgment against Drake arising from his negligence is dischargeable in his bankruptcy.

The unpaid federal income taxes are also dischargeable because they became due and owing more than three years prior to the filing of the bankruptcy petition.

The obligation to Bartin will not be discharged because the debt was not included in Drake's bankruptcy petition schedules and the creditor did not have notice or actual knowledge of the bankruptcy in time to file a proof of claim.

The unpaid child support is not dischargeable in Drake's bankruptcy.

b. To establish a preferential transfer that can be set aside, the bankruptcy trustee must show

- A voluntary or involuntary transfer of nonexempt property to a creditor.
- The transfer was made during the ninety days immediately preceding the bankruptcy filing (or within one year in the case of an "insider").
- The transfer was on account of an antecedent debt.
- The transfer was made while the debtor was insolvent.
- The transfer allows the creditor to receive a greater percentage than would otherwise be received in the bankruptcy proceeding.

c. The payment to Safe will be regarded as a preference and may be set aside by the trustee.

The transfer by Drake to his brother can be set aside as a preference since his brother would be considered an insider and payment was made within one year of filing.

Giving the mortgage to Home is not a preference because it was not on account of an antecedent debt.

The payment to Max is not a preference because it was made in the ordinary course of the business of Max and Drake under ordinary business terms.

M91

Answer 2 (10 points)

a. The requirements necessary for the commencement of an involuntary bankruptcy proceeding were met because the petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims aggregating more than $5,000. To properly commence an involuntary bankruptcy proceeding in which the debtor has 12 or more creditors with unsecured claims, three or more creditors with unsecured claims aggregating at least $5,000 must sign the bankruptcy petition.

b. 1. The court may declare the January 31, 1989, mortgage delivered to Safe by Tine to be void as a preference. A preference occurs if there is a transfer of the interest in property:

- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor before such transfer was made;
- Made while the debtor was insolvent;
- Made within 90 days before the date of the filing of the bankruptcy petition (when the creditor is not an insider);
- That enables the creditor to receive more than the creditor would receive in a liquidation proceeding.

Under the facts of this case, the mortgage delivered by Tine to Safe was for Safe's benefit, on account of the $250,000 owed to Safe, given while Tine was unable to pay his current obligations (was insolvent), given on January 31, 1989 (which was within 90 days before the filing of the bankruptcy petition on March 23, 1989), and enabled Safe to receive more than it would have received in a liquidation proceeding ($250,000 as a secured creditor vs. a lesser amount as an unsecured creditor in liquidation).

2. The court can except Tine's debt to Rich Bank from Tine's discharge in bankruptcy. In general, the bankruptcy court will except a debt from discharge if the debtor obtains money by use of a statement in writing respecting the debtor's financial condition that is materially false; the creditor to whom the debtor is liable for such money reasonably relied on the statement, and the debtor caused the statement to be made or published with intent to deceive.

Based on the facts of this case, Tine obtained a $50,000 loan after furnishing Rich with personal financial statements, that he knew substantially overstated his net worth. Because it was difficult to detect the overstatement, Rich's reliance on the financial statements was reasonable. Therefore, the requirements necessary to except Rich's debt from Tine's discharge have been met.

M87

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:

<table>
<thead>
<tr>
<th>Claimant</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carr</td>
<td>$20,000</td>
</tr>
<tr>
<td>Able</td>
<td>$120,000</td>
</tr>
<tr>
<td>Baker</td>
<td>$120,000</td>
</tr>
<tr>
<td>Total</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

V. Government Regulation of Business

A. Regulation of Employment

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.
Unofficial Answers

VI. Uniform Commercial Code

A. Commercial Paper

M91
Answer 3 (10 points)

Hillcraft's first assertion, that the note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand, is incorrect. The note is negotiable despite the reference to the license agreement because it does not make the note subject to the terms of the agreement; rather, the reference is regarded only as a recital of its existence.

Also, Hillcraft's right to extend the time for payment does not make the note nonnegotiable because the extension period is for a definite period of time.

Hillcraft's second assertion, that River Oaks is not a holder in due course (HDC) because it received the note as security for an existing debt and, therefore, did not give value for it, is incorrect. Under the UCC Commercial Paper Article, a holder does give value for an instrument when it is taken in payment of, or as security for, an antecedent claim.

Hillcraft's third assertion, that River Oaks is not an HDC because River Oaks was aware of Alexco's alleged breach of the license agreement, is correct. If a holder of a note is aware of a dispute when it acquires the note, that holder cannot be an HDC because it took with notice.

Hillcraft's fourth assertion, that it can raise the alleged breach by Alexco as a defense to payment of the note, is incorrect. Even though River Oaks is not an HDC under the UCC “shelter provision,” it is entitled to the protection of an HDC because it took the instrument from First Auto, which was an HDC. Therefore, River Oaks did not take the note subject to Hillcraft's defense based on the alleged breach by Alexco.

Hillcraft's defense is considered a personal defense and can only be used by Hillcraft against Alexco.

Hillcraft's fifth assertion, that River Oaks has no right to the note because it was not endorsed by Alexco, is incorrect. River Oaks acquired rights to the Hillcraft note without Alexco's endorsement because the note was a bearer instrument as a result of it being payable to "Alexco Company or bearer." A bearer instrument can be negotiated by delivery alone.

Hillcraft's final assertion, that the maximum amount Hillcraft would owe under the note is $4,000, plus accrued interest, is correct. If there is a conflict between a number written in numerals and also described by words, the words take precedence. Therefore, Hillcraft's maximum potential principal liability is $4,000 under the note.

M90
Answer 5 (10 points)

a. University is not a holder in due course (HDC) with regard to Peters’ note. To be an HDC, University must:

- Be a holder of a negotiable instrument.
- Take it for value.
- Take it in good faith.
- Take it without notice that it is overdue or has been dishonored.
- Take it without notice of any defense or claim to it.

All of the above requirements are met except the first. Peters' note is not negotiable because it is not made payable to bearer or to the order of a named payee.

b. University is an assignee of Harris' rights under Peters' note. Therefore, University "stands in the shoes" of Harris, and Peters can raise Harris' alleged misrepresentations as a defense against University.

c. 1. Cole's first claim is incorrect. The promissory note Cole executed is negotiable despite the reference to the construction contract, because it does not make the note subject to the other contract; rather, the reference is only a recital of that contract's existence.

2. Cole's second claim is incorrect. University acquired rights to the promissory note without Baker's indorsement because the note had been converted to a bearer instrument as a result of Able's blank indorsement. Bearer paper can be negotiated by delivery alone.

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 Uniform 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.

B. Documents of Title and Investment Securities

N89 Answer 5 (10 points)

West's assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation.

Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not declared by Ace's board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West's assertion that West is entitled to examine Ace's books and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

West's assertion that West is entitled to receive a new stock certificate to replace the lost stock certificate is correct. Because the subject matter in this case is a stock certificate of a corporation, the UCC Investment Securities Article applies. Under that article, the stock certificate of Ace is classified as a certified security because it is one of a class of Ace's shares that is represented by an instrument in West's name and is traded on a national securities exchange. If the owner of a certified security claims that the security has been lost, the issuer shall issue a new certificated security, or, at the option of the issuer, an equivalent uncertificated security in place of the original security if the owner makes a request before the issuer has notice that the security has been acquired by a bona fide purchaser; files a sufficient indemnity bond with the issuer; and satisfies any other reasonable requirements imposed by the issuer. Based on the facts of this case, West is entitled to receive a new stock certificate because West requested that a new stock certificate be issued before Ace had notice the lost certificate was acquired by any other party; offered to file an indemnity bond with Ace; and offered to cooperate with any reasonable requests made by Ace.

C. Sales

N90 Answer 4 (10 points)

a. Under the UCC Sales Article, the contract between Pharo and Secure creates the following implied warranties:

- Implied warranty of merchantability;
- Implied warranty of fitness for a particular purpose;
- Implied warranty of title.

The implied warranty of merchantability requires the tug to be merchantable; that is, fit for the ordinary purpose intended. It is probable that the tug was fit for such ordinary purposes and, therefore, the implied warranty of merchantability was not breached.

The implied warranty of fitness for a particular purpose requires that the tug be fit for the particular purpose for which it was purchased. To show that the implied warranty of fitness for a particular purpose is present as a result of the contract, Pharo must show that:

- Secure knew of the particular needs of Pharo;
- Pharo relied on Secure to select a suitable tug;
- Secure knew that Pharo was relying on Secure to select a tug suitable for Pharo's needs.

The implied warranty of fitness for a particular purpose has been breached because the tug was not suitable for Pharo's particular needs (i.e., to move airplanes weighing up to 10,000 pounds).

The implied warranty of title requires that:

- Secure have good title;
- The transfer to Pharo would be rightful;
- The tug would be delivered free from any security interest or other lien.

The implied warranty of title has been breached because Maco was the rightful owner.

b. Maco will not be entitled to recover the tug from Pharo because:

- Maco had entrusted the tug to Secure, which deals in similar goods;
Unofficial Answers

- That, as a result of such entrustment, Secure had the power to transfer Maco's rights to the tug to a buyer in the ordinary course of business;
- Pharo was a buyer in the ordinary course of business because Pharo purchased the tug in good faith and without knowledge of Maco's ownership interest.

M89
Answer 4 (10 points)

The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that Dix's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.

M89
Answer 5 (10 points)

The assertion that as of March 3, 1989 the risk of loss on the disk drive remained with Xeon is correct. Under the UCC Sales Article, if the agreement between the parties is otherwise silent, risk of loss passes to the buyer on the buyer's receipt of the goods if the seller is a merchant. Under the facts, Xeon is a merchant because it sells computer systems. Therefore, the risk of loss remained with Xeon because the disk drive was never received by Pine.

The assertion that Meed acquired no rights in the CPU as a result of the March 18, 1989 transaction is incorrect. Under the UCC Sales Article, any entrusting of possession of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all rights of the entruster to the buyer in the ordinary course of business. Entrusting includes any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence, and regardless of whether the possessor's disposition of the goods has been such as to be larcenous under the criminal law. For the merchant to acquire the power to transfer ownership and title, the entruster must be the rightful owner. Under the facts of this case, Pine had title at the time the CPU was returned to Xeon for repairs and this constituted an entrusting that gave Xeon the power to transfer all of Pine's rights in the CPU to Meed.

The assertion that Jensen's security interest in the word processors never attached and therefore Jensen's security interest is not enforceable against Pine with respect to the word processors is incorrect. A security interest in collateral will attach if: the collateral is in the possession of the secured party under an agreement, or the debtor has signed a security agreement that contains a description of the collateral; the secured party has given value; and the debtor has rights in the collateral. Based on the facts, Jensen's security interest attached on April 12, 1989, when Jensen sold and Pine received the word processors and Jensen received a security agreement executed by Pine that described the word processors. On attachment, Jensen's security interest became enforceable against Pine.

The assertion that Jensen has a superior security interest to Pine's bank is incorrect. Although Jensen has a purchase money security interest to the extent the security interest is taken by Jensen to secure the purchase price, Jensen's security interest will not be perfected by attachment alone. Jensen must file a financing statement to perfect its security interest because the collateral involved is goods used for business purposes and not consumer goods. Therefore, Jensen has an unperfected security interest in the word processors and the bank obtained a superior security interest by perfecting.
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.

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.
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.

D. Secured Transactions

N80

Answer 5 (10 points)

Kast’s assertion that the computer was purchased from Wizard free of National’s security interest is correct. Kast, as a buyer in the ordinary course, purchased the computer free of any security interest given by Wizard. The fact that Kast was aware of the existence of National’s security interest does not affect this conclusion.

Marc’s assertion that the computer was purchased from Kast free of Wizard’s security interest is correct. Marc purchased the computer from Kast free of Wizard’s security interest because:

- Marc had no knowledge of the security interest;
- Marc was buying the computer for household use;
- Wizard’s security interest had not been perfected by filing prior to Marc’s purchase.

Marc’s assertion that Alcor’s security interest is unenforceable against Marc because Alcor failed to file a financing statement is incorrect. On attachment of Alcor’s security interest, it became enforceable against Marc. Attachment has occurred because:

- The secured party (Alcor) gave value;
- The debtor (Marc) has rights in the collateral;
- The debtor (Marc) has executed and delivered a security agreement covering the collateral to the creditor (Alcor).

Alcor’s failure to perfect its security interest has no effect on the enforceability of the security interest against Marc.

M88

Answer 4 (10 points)

A purchase money security interest is an interest in personal property or fixtures that secures payment or performance of an obligation and that is (1) taken or retained by the seller of the collateral to secure all or part of its price, or (2) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Safe’s security interest has priority over the rights of the trustee in bankruptcy. The UCC Article on Secured Transactions states that a lien creditor includes a trustee in bankruptcy from the date of the filing of the petition. Under the general rule, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected. However, if the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a lien creditor that arise between the time the security interest attaches and the time of filing. Under the facts of our case, Safe has a purchase money security interest in the equipment because the security interest was taken by Safe to secure the price. Therefore, because Safe filed a financing statement on May 14 (within 10 days after Lux received possession of the equipment) it has a priority security interest over the trustee in bankruptcy (lien creditor) whose claim arose between the time the security interest attached (May 5) and the time of filing (May 14).

Safe has a priority security interest in the equipment over City. A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 10 days thereafter. Because Safe has a purchase
money security interest in the equipment that was perfected by filing a financing statement on May 14 (within 10 days after Lux received possession of the equipment on May 5). Safe has a priority security interest over City despite City's perfection of its security interest on May 12.

Best's security interest in the inventory has priority over Safe's security interest. In general, conflicting perfected security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither a filing nor perfection. In this case, because both Best's and Safe's security interests were perfected by filing, the first to file (Best) will have a priority security interest. The fact that Best filed a financing statement prior to making the loan will not affect Best's priority.

Safe will not have a priority security interest over Dix because Dix is a buyer in the ordinary course of business and will take free of Safe's perfected security interest. Dix is a buyer in the ordinary course of business because Dix acted in good faith when purchasing the machine parts in the regular course of Cam's business. The UCC Article on Secured Transactions states that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. Therefore, Dix will take the machine parts purchased from Cam's inventory on July 14, free from Safe's security interest which was perfected on July 12.

VII. Property

A. Real and Personal Property

N69 Answer 2 (10 points)

a. Sam Bean and Bob Bean will not be personally liable to Fale for the deficiency resulting from the foreclosure sale because they did not assume the mortgage but instead purchased the building subject to the mortgage. In the absence of a state statute to the contrary, Stein will be personally liable for the deficiency because Stein was not released from liability on the note and mortgage.

b. There is no right of survivorship feature in a tenancy in common and, therefore, Rita Bean will acquire Sam Bean's one-half interest in the building under her husband's will. Thus, Rita Bean will own a one-half interest in the building as a tenant in common with Bob Bean.

c. In general, the purposes and benefits of creating a spendthrift trust are to provide a fund for the maintenance of another (the beneficiary); protect the fund from the beneficiary's financial mismanagement and improvidence; prohibit the beneficiary from transferring the right to future trust income or principal; and prohibit the beneficiary's interest from being subjected to the claims of the beneficiary's creditors.

d1. A trust may generally be terminated by the beneficiaries if all consent to the termination; all are legally competent to consent; and termination will not defeat a material purpose for which the trust was created.

2. The spendthrift trust created by Sam Bean cannot be terminated by Bob Bean because the major purpose of a spendthrift trust is to protect the beneficiary from mismanagement and improvidence. Thus, termination of the spendthrift trust would defeat the purpose for which it was created.

N69 Answer 3 (10 points)

a. Ash, Bale, and Rangel will be personally liable to Vista for the deficiency resulting from the foreclosure sale because they became the principal debtors when they assumed the mortgage. Park will remain liable for the deficiency. Although Vista consented to the assumption of the mortgage by Ash, Bale, and Rangel, such assumption does not relieve Park from its obligation to Vista unless Park obtains a release from Vista or there is a novation.

b. The assertion that the sublet from Wein to Nord is void because Ash, Bale, and Rangel must consent to the sublet is incorrect. Unless the lease provides otherwise, a tenant may sublet the premises without the landlord's consent. Since the lease was silent regarding Wein's right to sublet, Wein may sublet to Nord without the consent of Ash, Bale, and Rangel.

The assertion that if the sublet was not void Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of rent is incorrect. In a sublease, the sublessee/subtenant (Nord) has no obligation to pay rent to the landlord (Ash, Bale, and Rangel).
The subtenant (Nord) is liable to the tenant (Wein), but the tenant (Wein) remains solely liable to the landlord (Ash, Bale, and Rangel) for the rent stipulated in the lease.

c. Ash's inter vivos transfer of his \( \frac{1}{2} \) interest in the office building to his spouse on April 4, 1989 resulted in his spouse obtaining a \( \frac{1}{2} \) interest in the office building as a tenant in common. Ash's wife did not become a joint tenant with Bale and Rangel because the transfer of a joint tenant's interest to an outside party destroys the joint tenancy nature of the particular interest transferred. Bale and Rangel will remain as joint tenants with each other.

As of April 21, 1989, the office building was owned by Ash's spouse who had a \( \frac{1}{2} \) interest as tenant in common and Bale who had a \( \frac{3}{2} \) interest as tenant in common.

Ash's death on April 20, 1989 will have no effect on the ownership of the office building because Ash had already transferred all of his interest to his wife on April 4, 1989.

Rangel's death on April 20, 1989 resulted in his interest being acquired by Bale because of the right of survivorship feature in a joint tenancy. Because there are no surviving joint tenants, Bale will become a tenant in common who owns \( \frac{3}{2} \) of the office building. Ash's spouse will not acquire any additional interest due to Rangel's death because she was a tenant in common with Rangel.

B. Mortgages

**M91 Answer 4 (10 points)**

a. Tower and Perry owned the property as tenants in common. This form of ownership allows either party to dispose of his or her undivided interest by sale or on death. Any person purchasing or inheriting Perry's interest would become a tenant in common with Tower. Thus, on January 21, 1990, Tower and Dodd are tenants in common, each owning a one-half undivided interest in the house.

b. Both Tower and Dodd have an insurable interest in the house. Tower's interest arose when the property was purchased, continued when the insurance policy was purchased, and still existed at the time of the fire loss.

Dodd's interest arose when Dodd inherited Perry's interest in the house. Acme's consent to the assignment of the policy to Tower and Dodd entitles Dodd to a share of the proceeds of the policy.

c. Acme would have to honor the insurance contract and pay part of the loss. Despite Tower and Perry not maintaining insurance coverage of 80% of the property's market value, the coinsurance clause allows for a percentage of recovery. The formula is as follows:

\[
\text{Amount of Coverage} = \text{Actual Market Value} \times \text{Coinsurance} \%	imes \text{Loss} \\
\]

This would allow a recovery as follows:

\[
\frac{200,000}{300,000} \times 0.8 = 150,000 \\
\]

d. The conflict between Midway and New would be resolved in favor of Midway. In a notice-race statute jurisdiction, New's knowledge of Midway's first mortgage would give Midway priority despite New's earlier filing. The insurance proceeds would be distributed as follows:

- $80,000 to Midway representing the balance due on the mortgage including accrued interest. This is due because Midway as a mortgagee is included as a contingent beneficiary in the policy.
- $40,000 to New for the same reasons as above but not paid unless and until Midway is fully paid.
- $30,000 to be divided equally between Tower and Dodd as tenants in common.

e. Tower would not be able to collect rent from Zimmer for the balance of the term of the lease because Zimmer moved as a result of the extensive fire damage to the apartment. The implied warranty of habitability would be considered breached by the landlord and a constructive eviction of Zimmer would be deemed to have taken place because the premises could no longer be used for their intended purpose. Constructive eviction releases both the landlord and the tenant from their obligations under the lease.

C. Fire and Casualty Insurance

**N88 Answer 2 (10 points)**

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to $190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for $200,000 and gave no new consideration.
for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay $200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire $80,000 from Pica is incorrect. Starr is only entitled to receive $64,000 from Pica calculated as follows:

\[
\frac{$160,000 \text{ (Amount of Insurance Coverage with Pica)}}{$200,000 \text{ (Total Amount Paid)}} \times $80,000 \text{ (Amount to be Paid)} = $64,000
\]

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.
Uniform CPA Examination

November 1991

Questions and Unofficial Answers

A Supplement to the Journal of Accountancy
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<td>N-78</td>
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<tr>
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<td>Answer 5</td>
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EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 6, 1991; 1:30 P.M. to 6:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

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<tr>
<th>No.</th>
<th>Point Value</th>
<th>Estimated Minutes</th>
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<td>4</td>
<td>10</td>
<td>45</td>
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<td>5</td>
<td>10</td>
<td>40</td>
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<tr>
<td></td>
<td>Totals</td>
<td>50</td>
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</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

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 multiple-choice answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. 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.

3. For Question Number 4, be sure to include the completed tear-out worksheet in the proper sequence with other answer sheets.

4. Answer all multiple-choice items on the printed multiple-choice answer sheet. You should attempt to answer all multiple-choice items. There is no penalty for incorrect responses. Since the multiple-choice items are computer-graded, your comments and calculations associated with them are not considered and should not be submitted. Be certain that you have entered your answers on the multiple-choice answer sheet before the examination time is up. The multiple-choice portion of your examination will not be graded if you fail to record your answers on the multiple-choice answer sheet.

5. 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. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.

6. 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 candidates' 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.

7. Write your 7-digit candidate number in the space provided at the upper right-hand corner of this page.

8. You must hand in your examination question booklet, multiple-choice answer sheet, and green problem answer worksheets. Your examination will not be graded unless your examination question booklet, multiple-choice answer sheet, and green problem answer worksheets are handed in before leaving the examination room.

9. If you want your examination question booklet mailed to you, write your name and address on the back cover, and place 52 cents postage in the space provided, unless otherwise instructed. Also, unless instructed otherwise, write your name and address in the return address space in the upper left-hand corner on the back cover. Examination question booklets will be distributed no sooner than the day following the administration of this examination, unless instructed otherwise.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.
Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple-choice items. Select the best answer for each of the items relating to a variety of financial accounting problems. Use a 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 correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Answer Sheet

97. a b c d

Number 1 (Estimated time — 45 to 55 minutes)

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

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

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

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

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

2. King Corp.'s trial balance for the year ended December 31, 1990, included the following:

\[
\begin{array}{ccc}
\text{Debit} & \text{Credit} \\
\text{Sales} & \text{Sales} & \text{Cost of sales} & 120,000 \\
\text{Administrative expenses} & 30,000 \\
\text{Loss on sale of equipment} & 18,000 \\
\text{Sales commissions} & 20,000 \\
\text{Interest revenue} & 10,000 \\
\text{Freight out} & 6,000 \\
\text{Loss on early retirement of long-term debt} & 20,000 \\
\text{Bad debt expense} & 6,000 \\
\text{Totals} & \text{Debit} & 220,000 \\
\text{Credit} & 310,000 \\
\end{array}
\]

Other information

Finished goods inventory:

| January 1, 1990 | $200,000 |
| December 31, 1990 | 180,000 |

In King's 1990 multiple-step income statement, the cost of goods manufactured was

a. $100,000
b. $106,000
c. $140,000
d. $146,000

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

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

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

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

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

a. $5,600
b. $4,480
c. $2,800
d. $2,240
Accounting Practice — Part I

Items 5 through 7 are based on the following:

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

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

The following additional information relates to 1990:

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

In Beal's 1990 statement of cash flows,

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

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

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

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

   Man Co. | $10,000 | $8,000 | $8,000
   Kemo, Inc. | 9,000 | 11,000 | 9,000
   Fenn Corp. | 11,000 | 9,000 | 9,000

   Ott's December 31, 1990, balance sheet should report the marketable equity securities as
   a. $26,000
   b. $28,000
   c. $29,000
   d. $30,000

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

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

   Ashe should make four annual deposits (rounded) of
   a. $250,000
   b. $215,500
   c. $195,700
   d. $146,000
10. Mr. & Mrs. Dart own a majority of the outstanding capital stock of Wall Corp., Black Co., and West, Inc. During 1990, Wall advanced cash to Black and West in the amount of $50,000 and $80,000, respectively. West advanced $70,000 in cash to Black. At December 31, 1990, none of the advances was repaid. In the combined December 31, 1990, balance sheet of these companies, what amount would be reported as receivables from affiliates?
   a. $200,000
   b. $130,000
   c. $ 60,000
   d. $0

11. On July 1, 1989, Gee, Inc. leased a delivery truck from Marr Corp. under a 3-year operating lease. Total rent for the term of the lease will be $36,000, payable as follows:
   
   12 months at $500 = $ 6,000
   12 months at $750 = 9,000
   12 months at $1,750 = 21,000

   All payments were made when due. In Marr's June 30, 1991, balance sheet, the accrued rent receivable should be reported as
   a. $0
   b. $ 9,000
   c. $12,000
   d. $21,000

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

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Packaging for shipment</td>
<td>$1,000</td>
</tr>
<tr>
<td>Shipping</td>
<td>1,500</td>
</tr>
<tr>
<td>Special handling charges</td>
<td>2,000</td>
</tr>
</tbody>
</table>

   These goods were received on December 31, 1990. In Kerr's December 31, 1990, balance sheet, what amount of cost for these goods should be included in inventory?
   a. $54,500
   b. $53,500
   c. $52,000
   d. $50,000

13. In 1989, Cobb adopted the dollar-value LIFO inventory method. At that time, Cobb's ending inventory had a base-year cost and an end-of-year cost of $300,000. In 1990, the ending inventory had a $400,000 base-year cost and a $440,000 end-of-year cost. What dollar-value LIFO inventory cost would be reported in Cobb's December 31, 1990, balance sheet?
   a. $440,000
   b. $430,000
   c. $410,000
   d. $400,000

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

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

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

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

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

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

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

17. On July 1, 1991, Lee Co. sold goods in exchange for a $200,000, 8-month, noninterest-bearing note receivable. At the time of the sale, the note's market rate of interest was 12%. What amount did Lee receive when it discounted the note at 10% on September 1, 1991?
   a. $194,000
   b. $193,800
   c. $190,000
   d. $188,000
18. On January 1, 1986, Lane, Inc. acquired equipment for $100,000 with an estimated 10-year useful life. Lane estimated a $10,000 salvage value and used the straight-line method of depreciation. During 1990, after its 1989 financial statements had been issued, Lane determined that, due to obsolescence, this equipment's remaining useful life was only four more years and its salvage value would be $4,000. In Lane's December 31, 1990, balance sheet, what was the carrying amount of this asset?
   a. $51,500
   b. $49,000
   c. $41,500
   d. $39,000

19. A state government condemned Cory Co.'s parcel of real estate. Cory will receive $750,000 for this property, which has a carrying amount of $575,000. Cory incurred the following costs as a result of the condemnation:
   - Appraisal fees to support a $750,000 value: $2,500
   - Attorney fees for the closing of the state: 3,500
   - Attorney fees to review contract to acquire replacement property: 3,000
   - Title insurance on replacement property: 4,000
What amount of cost should Cory use to determine the gain on the condemnation?
   a. $581,000
   b. $582,000
   c. $584,000
   d. $588,000

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

<table>
<thead>
<tr>
<th>Carrying amount</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$240,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$270,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$435,000</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>$1,305,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>($252,000)</td>
</tr>
<tr>
<td>Net assets</td>
<td>$1,725,000</td>
</tr>
</tbody>
</table>

What is the amount of goodwill resulting from the business combination?
   a. $175,000
   b. $105,000
   c. $70,000
   d. $0

21. At December 31, 1990, Cain, Inc. owed notes payable of $1,750,000, due on May 15, 1991. Cain expects to retire this debt with proceeds from the sale of 100,000 shares of its common stock. The stock was sold for $15 per share on March 10, 1991, prior to the issuance of the year-end financial statements. In Cain's December 31, 1990, balance sheet, what amount of the notes payable should be excluded from current liabilities?
   a. $0
   b. $250,000
   c. $1,500,000
   d. $1,750,000

22. Wolf Co.'s grant of 30,000 stock appreciation rights enables key employees to receive cash equal to the difference between $20 and the market price of the stock on the date each right is exercised. The service period is 1989 through 1991, and the rights are exercisable in 1992 and 1993. The market price of the stock was $25 and $28 at December 31, 1989 and 1990, respectively. What amount should Wolf report as the liability under the stock appreciation rights plan in its December 31, 1990, balance sheet?
   a. $0
   b. $130,000
   c. $160,000
   d. $240,000

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected benefit obligation</td>
<td>$14,500,000</td>
</tr>
<tr>
<td>Accumulated benefit obligation</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Unfunded accrued pension cost</td>
<td>200,000</td>
</tr>
<tr>
<td>Plan assets at fair market value</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>2,550,000</td>
</tr>
</tbody>
</table>

To report the proper pension liability in Ward's May 31, 1990, balance sheet, what is the amount of the adjustment required?
   a. $2,250,000
   b. $4,750,000
   c. $4,800,000
   d. $7,300,000

24. On September 1, 1991, Hall Corp. redeemed $500,000 of its 12%, 15-year bonds. Related unamortized bond premium and issue costs at that date were $8,000 and $10,000, respectively. What amount should Hall use to determine gain or loss on redemption?
   a. $518,000
   b. $508,000
   c. $502,000
   d. $498,000
25. Dunn Co.'s 1990 income statement reported $90,000 income before provision for income taxes. To compute the provision for federal income taxes, the following 1990 data are provided:

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

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

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

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

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

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

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

28. On October 1, 1990, Brock, Inc. issued 200 of its 10%, $1,000 bonds at 101 plus accrued interest. The bonds are dated July 1, 1990, and mature on July 1, 2000. Interest is payable semiannually on January 1 and July 1. At the time of issuance, Brock received cash of

a. $207,000
b. $205,000
c. $202,000
d. $197,000

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

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

In its December 31, 1990, balance sheet, Winn should report deferred subscription revenue of

a. $2,700,000
b. $1,800,000
c. $1,650,000
d. $900,000

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

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

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

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

31. On January 1, 1990, Dell, Inc. contracted with the city of Little to provide custom built desks for the city schools. The contract made Dell the city’s sole supplier and required Dell to supply no less than 4,000 desks and no more than 5,500 desks per year for two years. In turn, Little agreed to pay a fixed price of $110 per desk. During 1990, Dell produced 5,000 desks for Little. At December 31, 1990, 500 of these desks were segregated from the regular inventory and were accepted and awaiting pickup by Little. Little paid Dell $450,000 during 1990. What amount should Dell recognize as contract revenue in 1990?

a. $450,000
b. $495,000
c. $550,000
d. $605,000
32. Lake Corp., a newly organized company, reported pretax financial income of $100,000 for 1990. Among the items reported in Lake's 1990 income statement are the following:

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

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

- $28,500
- $ 4,500
- $ 3,750
- $0

33. On December 31, 1990, Day Co. leased a new machine from Parr with the following pertinent information:

Lease term 6 years
Annual rental payable at beginning $50,000 of each year
Useful life of machine 8 years
Day's incremental borrowing rate 15%
Implicit interest rate in lease (known by Day) 12%
Present value of an annuity of 1 in advance for 6 periods at
12% 4.61
15% 4.35

The lease is not renewable, and the machine reverts to Parr at the termination of the lease. The cost of the machine on Parr's accounting records is $375,500. At the beginning of the lease term, Day should record a lease liability of:

- $375,500
- $230,500
- $217,500
- $0

34. On December 31, 1989, Adam Co. leased a machine under a capital lease for a period of ten years, contracting to pay $50,000 on signing the lease and $50,000 annually on December 31 of the next nine years. The present value at December 31, 1989, of the ten lease payments over the lease term discounted at 10% was $338,000. At December 31, 1990, Adam's total capital lease liability is:

- $303,980
- $266,800
- $259,200
- $243,000

35. In its 1990 income statement, Tow, Inc. reported proceeds from an officer's life insurance policy of $90,000 and depreciation of $250,000. Tow was the owner and beneficiary of the life insurance on its officer. Tow deducted depreciation of $370,000 in its 1990 income tax return when the tax rate was 50%. Data related to the reversal of the excess tax deduction for depreciation follow:

<table>
<thead>
<tr>
<th>Year</th>
<th>Reversal of excess tax deduction</th>
<th>Enacted tax rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$50,000</td>
<td>35%</td>
</tr>
<tr>
<td>1992</td>
<td>40,000</td>
<td>35%</td>
</tr>
<tr>
<td>1993</td>
<td>20,000</td>
<td>25%</td>
</tr>
<tr>
<td>1994</td>
<td>10,000</td>
<td>25%</td>
</tr>
</tbody>
</table>

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

- $36,000
- $39,000
- $63,000
- $66,000

36. On January 1, 1990, Celt Corp. issued 9% bonds in the face amount of $1,000,000, which mature on January 1, 2000. The bonds were issued for $939,000 to yield 10%, resulting in a bond discount of $61,000. Celt uses the interest method of amortizing bond discount. Interest is payable annually on December 31. At December 31, 1990, Celt's unamortized bond discount should be:

- $51,000
- $51,610
- $52,000
- $57,100

37. Clay Corp. had $600,000 convertible 8% bonds outstanding at June 30, 1990. Each $1,000 bond was convertible into 10 shares of Clay's $50 par value common stock. On July 1, 1990, the interest was paid to bondholders, and the bonds were converted into common stock, which had a fair market value of $75 per share. The unamortized premium on these bonds was $12,000 at the date of conversion. Under the book value method, this conversion increased the following elements of the stockholders' equity section by:

<table>
<thead>
<tr>
<th>Common stock</th>
<th>Additional paid-in capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $300,000</td>
<td>$312,000</td>
</tr>
<tr>
<td>b. $306,000</td>
<td>$306,000</td>
</tr>
<tr>
<td>c. $450,000</td>
<td>$162,000</td>
</tr>
<tr>
<td>d. $600,000</td>
<td>$ 12,000</td>
</tr>
</tbody>
</table>
38. Mill, which began operations on January 1, 1988, recognizes income from long-term construction contracts under the percentage-of-completion method in its financial statements and under the completed contract method for income tax reporting. Income under each method follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Completed contract</th>
<th>Percentage-of-completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>$ —</td>
<td>$300,000</td>
</tr>
<tr>
<td>1989</td>
<td>400,000</td>
<td>600,000</td>
</tr>
<tr>
<td>1990</td>
<td>700,000</td>
<td>850,000</td>
</tr>
</tbody>
</table>

The income tax rate was 30% for 1988 through 1990. For years after 1990, the enacted tax rate is 25%. There are no other temporary differences. Mill elected early application of FASB Statement No. 96, Accounting for Income Taxes. Mill should report in its December 31, 1990, balance sheet, a deferred income tax liability of
a. $87,500
b. $105,000
c. $162,500
d. $195,000

39. East Corp. manufactures stereo systems that carry a two-year warranty against defects. Based on past experience, warranty costs are estimated at 4% of sales for the warranty period. During 1990, stereo system sales totaled $3,000,000, and warranty costs of $67,500 were incurred. In its income statement for the year ended December 31, 1990, East should report warranty expense of
a. $52,500
b. $60,000
c. $67,500
d. $120,000

40. State Co. recognizes construction revenue and expenses using the percentage-of-completion method. During 1989, a single long-term project was begun, which continued through 1990. Information on the project follows:

<table>
<thead>
<tr>
<th>Accounts receivable from construction contract</th>
<th>1989</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction expenses</td>
<td>105,000</td>
<td>192,000</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>122,000</td>
<td>364,000</td>
</tr>
<tr>
<td>Partial billings on contract</td>
<td>100,000</td>
<td>420,000</td>
</tr>
</tbody>
</table>

Profit recognized from the long-term construction contract in 1990 should be
a. $50,000
b. $108,000
c. $128,000
d. $228,000

Number 3 (Estimated time — 45 to 55 minutes)

41. On January 1, 1989, Mega Corp. acquired 10% of the outstanding voting stock of Penny, Inc. On January 2, 1990, Mega gained the ability to exercise significant influence over financial and operating control of Penny by acquiring an additional 20% of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, 1989 and 1990, Penny reported the following:

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends paid</td>
<td>$200,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Net income</td>
<td>600,000</td>
<td>650,000</td>
</tr>
</tbody>
</table>

In 1990, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to 1989 investment income?

<table>
<thead>
<tr>
<th>1990 investment income</th>
<th>Adjustment to 1989 investment income</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $195,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>b. $195,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>c. $195,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>d. $105,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

42. Cap Corp. reported accrued investment interest receivable of $38,000 and $46,500 at January 1 and December 31, 1990, respectively. During 1990, cash collections from the investments included the following:

Capital gains distributions $145,000
Interest 152,000

What amount should Cap report as interest revenue from investments for 1990?

a. $160,500
b. $153,500
c. $152,000
dl. $143,500

43. During 1990, Colt Co. experienced financial difficulties and is likely to default on a $1,000,000, 15%, 3-year note dated January 1, 1989, payable to Cain National Bank. On December 31, 1990, the bank agreed to settle the note and unpaid 1990 interest of $150,000 for $820,000 cash payable on January 31, 1991. What is the amount of gain, before income taxes, from the debt restructuring?

a. $0
b. $150,000
c. $180,000
dl. $330,000
44. In 1990, Neil Co. held the following investments in common stock:

- 25,000 shares of B & K, Inc.'s 100,000 outstanding shares. Neil's level of ownership gives it the ability to exercise significant influence over the financial and operating policies of B & K.
- 6,000 shares of Amal Corp.'s 309,000 outstanding shares.

During 1990, Neil received the following distributions from its common stock investments:

November 6 — $30,000 cash dividend from B & K.
November 11 — $1,500 cash dividend from Amal.
December 26 — 3% common stock dividend from Amal. The closing price of this stock on a national exchange was $15 per share.

What amount of dividend revenue should Neil report for 1990?

a. $1,500
b. $4,200
c. $31,500
d. $34,200

45. Munn Corp.'s income statements for the years ended December 31, 1990 and 1989, included the following, before adjustments:

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$800,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Gain on sale of division</td>
<td>$450,000</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>1,250,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>$375,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$875,000</td>
<td>$420,000</td>
</tr>
</tbody>
</table>

On January 1, 1990, Munn agreed to sell the assets and product line of one of its operating divisions for $1,600,000. The sale was consummated on December 31, 1990, and resulted in a gain on disposition of $450,000. This division's net losses were $320,000 in 1990 and $250,000 in 1989. The income tax rate for both years was 30%. In preparing revised comparative income statements, Munn should report which of the following amounts of gain (loss) from discontinued operations

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$130,000</td>
<td>$0</td>
</tr>
<tr>
<td>b.</td>
<td>$130,000</td>
<td>$(250,000)</td>
</tr>
<tr>
<td>c.</td>
<td>$91,000</td>
<td>$0</td>
</tr>
<tr>
<td>d.</td>
<td>$91,000</td>
<td>$(175,000)</td>
</tr>
</tbody>
</table>

46. On September 1, 1990, Cano & Co., a U.S. corporation, sold merchandise to a foreign firm for 250,000 francs. Terms of the sale require payment in francs on February 1, 1991. On September 1, 1990, the spot exchange rate was $.20 per franc. At December 31, 1990, Cano's year end, the spot rate was $.19, but the rate increased to $.22 by February 1, 1991, when payment was received. How much should Cano report as foreign exchange gain or loss in its 1991 income statement?

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

47. In 1990, Ball Labs incurred the following costs:

Direct costs of doing contract research and development work for the government to be reimbursed by governmental unit $400,000

Research and development costs not included above were:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation</td>
<td>$300,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>$700,000</td>
</tr>
<tr>
<td>Indirect costs appropriately allocated</td>
<td>$200,000</td>
</tr>
<tr>
<td>Materials</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

What was Ball's total research and development expense in 1990?

a. $1,080,000
b. $1,380,000
c. $1,580,000
d. $1,780,000

48. Leer Corp.'s pretax income in 1990 was $100,000. The temporary differences between amounts reported in the financial statements and the tax return are as follows:

- Depreciation in the financial statements was $8,000 more than tax depreciation.
- The equity method of accounting resulted in financial statement income of $35,000. A $25,000 dividend was received during the year, which is eligible for the 80% dividends received deduction.

Leer's effective income tax rate was 30% in 1990. In its 1990 income statement, Leer should report a current provision for income taxes of

a. $26,400
b. $23,400
c. $21,900
d. $18,600
49. Seldin Co. owns a royalty interest in an oil well. The contract stipulates that Seldin will receive royalty payments semiannually on January 31 and July 31. The January 31 payment will be for 20% of the oil sold to jobbers between the previous June 1 and November 30, and the July 31 payment will be for oil sold between the previous December 1 and May 31. Royalty receipts for 1990 amounted to $80,000 and $100,000 on January 31 and July 31, respectively. On December 31, 1989, accrued royalty revenue receivable amounted to $15,000. Production reports show the following oil sales:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1, 1989</td>
<td>$400,000</td>
</tr>
<tr>
<td>December 1, 1989</td>
<td>500,000</td>
</tr>
<tr>
<td>June 1, 1990</td>
<td>425,000</td>
</tr>
<tr>
<td>December 1, 1990</td>
<td>70,000</td>
</tr>
</tbody>
</table>

What amount should Seldin report as royalty revenue for 1990?

a. $179,000  
b. $180,000  
c. $184,000  
d. $194,000  

Items 50 and 51 are based on the following:

During 1990, Fuqua Steel Co. had the following unusual financial events occur:

- Bonds payable were retired five years before their scheduled maturity, resulting in a $260,000 gain. Fuqua has frequently retired bonds early when interest rates declined significantly.
- A steel forming segment suffered $255,000 in losses due to hurricane damage. This was the fourth similar loss sustained in a 5-year period at that location.
- A segment of Fuqua's operations, steel transportation, was sold at a net loss of $350,000. This was Fuqua's first divestiture of one of its operating segments.

50. Before income taxes, what amount of gain (loss) should be reported separately as a component of income from continuing operations in 1990?

a. $260,000  

51. Before income taxes, what amount should be disclosed as the gain (loss) from extraordinary items in 1990?

a. $260,000  

52. In 1985, May Corp. acquired land by paying $75,000 down and signing a note with a maturity value of $1,000,000. On the note's due date, December 31, 1990, May owed $40,000 of accrued interest and $1,000,000 principal on the note. May was in financial difficulty and was unable to make any payments. May and the bank agreed to amend the note as follows:

- The $40,000 of interest due on December 31, 1990, was forgiven.
- The principal of the note was reduced from $1,000,000 to $950,000 and the maturity date extended 1 year to December 31, 1991.
- May would be required to make one interest payment totaling $30,000 on December 31, 1991.

As a result of the troubled debt restructuring, May should report a gain, before taxes, in its 1990 income statement of

a. $40,000  
b. $50,000  
c. $60,000  
d. $90,000  

53. During 1990, Pard Corp. sold goods to its 80% owned subsidiary, Seed Corp. At December 31, 1990, one-half of these goods were included in Seed's ending inventory. Reported 1990 selling expenses were $1,100,000 and $400,000 for Pard and Seed, respectively. Pard's selling expenses included $50,000 in freight-out costs for goods sold to Seed. What amount of selling expenses should be reported in Pard's 1990 consolidated income statement?

a. $1,500,000  
b. $1,480,000  
c. $1,475,000  
d. $1,450,000  

54. Loeb Corp. frequently borrows from the bank in order to maintain sufficient operating cash. The following loans were at a 12% interest rate, with interest payable at maturity. Loeb repaid each loan on its scheduled maturity date.

<table>
<thead>
<tr>
<th>Date of loan</th>
<th>Amount</th>
<th>Maturity date</th>
<th>Term of loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/1/89</td>
<td>$5,000</td>
<td>10/31/90</td>
<td>1 Year</td>
</tr>
<tr>
<td>2/1/90</td>
<td>15,000</td>
<td>7/31/90</td>
<td>6 Months</td>
</tr>
<tr>
<td>5/1/90</td>
<td>8,000</td>
<td>1/31/91</td>
<td>9 Months</td>
</tr>
</tbody>
</table>

Loeb records interest expense when the loans are repaid. As a result, interest expense of $1,500 was recorded in 1990. If no correction is made, by what amount would 1990 interest expense be understated?

a. $540  
b. $620  
c. $640  
d. $720  

N-10
55. On January 1, 1990, Moul Mining Co. (lessee), entered into a 5-year lease for drilling equipment. Moul accounted for the acquisition as a capital lease for $120,000, which includes a $5,000 bargain purchase option. At the end of the lease, Moul expects to exercise the bargain purchase option. Moul estimates that the equipment's fair value will be $10,000 at the end of its 8-year life. Moul regularly uses straight-line depreciation on similar equipment. For the year ended December 31, 1990, what amount should Moul recognize as depreciation expense on the leased asset?
   a. $13,750
   b. $15,000
   c. $23,000
   d. $24,000

56. Goddard has used the FIFO method of inventory valuation since it began operations in 1987. Goddard decided to change to the weighted-average method for determining inventory costs at the beginning of 1990. The following schedule shows year-end inventory balances under the FIFO and weighted-average methods:

<table>
<thead>
<tr>
<th>Year</th>
<th>FIFO</th>
<th>Weighted-average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>$45,000</td>
<td>$54,000</td>
</tr>
<tr>
<td>1988</td>
<td>78,000</td>
<td>71,000</td>
</tr>
<tr>
<td>1989</td>
<td>83,000</td>
<td>78,000</td>
</tr>
</tbody>
</table>

What amount, before income taxes, should be reported in the 1990 income statement as the cumulative effect of the change in accounting principle?
   a. $5,000 decrease.
   b. $3,000 decrease.
   c. $2,000 increase.
   d. $0.

57. E & S partnership purchased land for $500,000 on May 1, 1987, paying $100,000 cash and giving a $400,000 note payable to Big State Bank. E & S made three annual payments on the note totaling $179,000, which included interest of $89,000. E & S then defaulted on the note. Title to the land was transferred by E & S to Big State, which cancelled the note, releasing the partnership from further liability. At the time of the default, the fair value of the land approximated the note balance. In E & S's 1990 income statement, the amount of the loss should be
   a. $279,000
   b. $221,000
   c. $190,000
   d. $100,000

58. On August 1, 1990, Metro, Inc. leased a luxury apartment unit to Klum. The parties signed a 1-year lease beginning September 1, 1990, for a $1,000 monthly rent payable on the first day of the month. At the August 1 signing date, Metro collected $540 as a nonrefundable fee for allowing Klum to sign a 1-year lease (the normal lease term is three years) and $1,000 rent for September. Klum has made timely payments each month, but prepaid January's rent on December 20. In Metro's 1990 income statement, rent revenue should be reported as
   a. $4,000
   b. $4,180
   c. $4,540
   d. $5,180

59. Shear, Inc. began operations in 1990. Included in Shear's 1990 financial statements were bad debt expenses of $1,400 and profit from an installment sale of $2,600. For tax purposes, the bad debts will be deducted and the profit from the installment sale will be recognized in 1992. The enacted tax rates are 30% in 1990 and 25% in 1992. Shear elected early application of FASB Statement No. 96, Accounting for Income Taxes. In its 1990 income statement, what amount should Shear report as deferred income tax expense?
   a. $300
   b. $360
   c. $650
   d. $780

60. Strauch Co. has one class of common stock outstanding and no other securities that are potentially convertible into common stock. During 1989, 100,000 shares of common stock were outstanding. In 1990, two distributions of additional common shares occurred: On April 1, 20,000 shares of treasury stock were sold, and on July 1, a 2-for-1 stock split was issued. Net income was $410,000 in 1990 and $350,000 in 1989. What amounts should Strauch report as earnings per share in its 1990 and 1989 comparative income statements?

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$1.78</td>
<td>$3.50</td>
</tr>
<tr>
<td>b.</td>
<td>$1.78</td>
<td>$1.75</td>
</tr>
<tr>
<td>c.</td>
<td>$2.34</td>
<td>$1.75</td>
</tr>
<tr>
<td>d.</td>
<td>$2.34</td>
<td>$3.50</td>
</tr>
</tbody>
</table>
Number 4 (Estimated time — 45 to 55 minutes)

The following information pertains to Dey Toys, a calendar-year sole proprietorship, which maintained its books on the cash basis during the year.

**Dey Toys**

**Trial Balance**

**December 31, 1990**

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>8,200</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable, 12/31/89</td>
<td>9,000</td>
<td></td>
</tr>
<tr>
<td>Inventory, 12/31/89</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Machinery &amp; equipment</td>
<td>70,000</td>
<td></td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>28,800</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation, 12/31/89</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable, 12/31/89</td>
<td>9,600</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>1,700</td>
<td></td>
</tr>
<tr>
<td>Dey, drawings</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Dey, capital, 12/31/89</td>
<td>67,300</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>374,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>165,400</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>107,000</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>5,800</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>4,800</td>
<td></td>
</tr>
<tr>
<td>Dey's living expenses</td>
<td>7,800</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>16,800</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>470,600</strong></td>
<td><strong>470,600</strong></td>
</tr>
</tbody>
</table>

During 1990, Dey signed a new 8-year lease for its retail store and is in the process of negotiating a loan to remodel the premises. The bank requires Dey to present 1990 financial statements on the accrual basis of accounting. During the course of a review engagement, Dey's accountant obtained the following additional information:

1. Amounts due from customers totaled $17,800 at December 31, 1990.
2. An analysis of the above receivables revealed that an allowance for uncollectible accounts of $2,100 should be provided.
3. The inventory totaled $46,000 based on a physical count of the goods at December 31, 1990. The inventory was priced at cost, which approximates market value.
4. On April 1, 1990, Dey paid $4,800 to renew its comprehensive insurance coverage for one year. The premium was $4,320 on the previous policy that expired on March 31, 1990.
5. On signing the new lease for the retail store on October 1, 1990, Dey paid $16,800 for one year's advance rent for the lease year ending September 30, 1991. The $15,000 annual rent under the previous lease was paid on October 1, 1989, for the lease year ended September 30, 1990.
6. In anticipation of signing a new lease, Dey constructed storage space that cost $28,800. The improvements were completed on October 1, 1990, and have an estimated useful life of 10 years. No provision for depreciation or amortization has been recorded. Depreciation on machinery and equipment was $10,600 for 1990.
7. Unpaid invoices for toy purchases totaled $18,600 at December 31, 1990.
8. Accrued expenses at December 31, 1989 and 1990, were as follows:

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utilities</td>
<td>$500</td>
<td>$850</td>
</tr>
<tr>
<td>Salaries</td>
<td>500</td>
<td>770</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>600</td>
<td>900</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,600</strong></td>
<td><strong>$2,520</strong></td>
</tr>
</tbody>
</table>

9. Dey is being sued for $175,000. The coverage under the comprehensive insurance policy is limited to $100,000. Dey's attorney believes that an unfavorable outcome is probable and a reasonable estimate of the settlement is $135,000.

10. The salaries account includes $4,000 per month paid to the proprietor. Dey also receives $150 per week for living expenses.

**Required:** Detach and complete the tear-out worksheet on page 13. Turn in the worksheet in the proper sequence with other answer sheets.

a. Complete the tear-out worksheet to convert the trial balance of Dey Toys to the accrual basis of accounting for the year ended December 31, 1990. Formal journal entries are not required to support your adjustments. However, use the numbers given with the additional information to cross reference the postings in the adjustment columns on the worksheet.

b. Prepare a statement of changes in Dey's capital for the year ended December 31, 1990.
**Dey Toys**  
**WORKSHEET TO CONVERT**  
**TRIAL BALANCE TO ACCRUAL BASIS**  
*December 31, 1990*

<table>
<thead>
<tr>
<th>Account Title</th>
<th>Cash Basis</th>
<th>Adjustments</th>
<th>Accrual Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>8,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>9,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Machinery &amp; equipment</td>
<td>70,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>28,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation &amp; amort.</td>
<td>18,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>9,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>1,700</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dey, drawings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dey, capital</td>
<td>67,300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td>374,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>165,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>107,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>5,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>4,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dey’s living expenses</td>
<td>7,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>16,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>7,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>470,600</td>
<td>470,600</td>
<td></td>
</tr>
</tbody>
</table>

**DETACH, COMPLETE, AND TURN IN THIS TEAR-OUT WORKSHEET IN THE PROPER SEQUENCE WITH OTHER ANSWER SHEETS.**
Number 5 (Estimated time — 40 to 50 minutes)

Pine Corp. issued 200,000 shares of its $10 par common stock on March 31, 1990, to acquire all of the outstanding $25 par value common stock of Strand, Inc. The business combination meets all conditions for a pooling of interests. On March 31, 1990, the market price of Pine’s common stock was $35 a share. Both corporations continued to operate as separate businesses, maintaining separate accounting records with years ending December 31.

On March 31, 1990, immediately before the combination, the stockholders’ equities were

<table>
<thead>
<tr>
<th></th>
<th>Pine</th>
<th>Strand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$ 5,500,000</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>4,200,000</td>
<td>470,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>7,360,000</td>
<td>2,430,000</td>
</tr>
<tr>
<td></td>
<td>$17,060,000</td>
<td>$5,400,000</td>
</tr>
</tbody>
</table>

Additional information

- During March 1990, Pine paid $720,000 for expenditures relating to the business combination with Strand.
- Pine accounts for its investment in Strand using the equity method.
- On March 31, 1990, the fair values of Strand’s assets and liabilities equaled their book values, except for its long-term investment in marketable equity securities, for which the aggregate market value exceeded aggregate cost by $600,000.
- On March 10, 1990, Strand paid a cash dividend totaling $250,000 on its common stock.
- On November 15, 1990, Pine paid a cash dividend totaling $1,500,000 on its common stock.
- During August 1990, Pine sold merchandise to Strand at a profit of $800,000. At December 31, 1990, one-fourth of this merchandise remained in Strand’s inventory.
- For the period April 1 through December 31, 1990, Strand paid Pine management fees totaling $150,000.
- Strand’s 1990 net income was $1,450,000. Pine’s 1990 income was $2,240,000, before considering equity in Strand’s net income.
- The balances in retained earnings at December 31, 1989, were $6,820,000 and $2,290,000 for Pine and Strand, respectively.

Required:

a. Prepare Pine Corp.’s journal entries to record the business combination with Strand, Inc. and the expenditures relating to the business combination.


c. Prepare a formal consolidated statement of changes in retained earnings of Pine Corp. and its subsidiary Strand, Inc. for the year ended December 31, 1990.
EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 7, 1991; 1:30 P.M. to 6:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Point Value</th>
<th>Estimated Minutes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
<td>45</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>55</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>Totals</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>220</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

Failure to follow these instructions may have an adverse effect on your examination grade

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 multiple-choice answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. 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.

3. Answer all multiple-choice items on the printed multiple-choice answer sheet. You should attempt to answer all multiple-choice items. There is no penalty for incorrect responses. Since the multiple-choice items are computer-graded, your comments and calculations associated with them are not considered and should not be submitted. Be certain that you have entered your answers on the multiple-choice answer sheet before the examination time is up. The multiple-choice portion of your examination will not be graded if you fail to record your answers on the multiple-choice answer sheet.

4. 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. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.

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 candidates’ knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. Write your 7-digit candidate number in the space provided at the upper right-hand corner of this page.

7. You must hand in your examination question booklet, multiple-choice answer sheet, and green problem answer worksheets. Your examination will not be graded unless your examination question booklet, multiple-choice answer sheet, and green problem answer worksheets are handed in before leaving the examination room.

8. If you want your examination question booklet mailed to you, write your name and address on the back cover, and place 52 cents postage in the space provided, unless otherwise instructed. Also, unless instructed otherwise, write your name and address in the return address space in the upper left-hand corner on the back cover. Examination question booklets will be distributed no sooner than the day following the administration of this examination, unless instructed otherwise.

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 1991

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 correct answers.

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.

1. Of the 125,000 shares of common stock issued by Vey Corp., 25,000 shares were held as treasury stock at December 31, 1989. During 1990, transactions involving Vey's common stock were as follows:

January 1 through October 31 — 13,000 treasury shares were distributed to officers as part of a stock compensation plan.

November 1 — A 3-for-1 stock split took effect.

December 1 — Vey purchased 5,000 of its own shares to discourage an unfriendly takeover. These shares were not retired.

At December 31, 1990, how many shares of Vey's common stock were issued and outstanding?

<table>
<thead>
<tr>
<th>Shares</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued</td>
<td>Outstanding</td>
</tr>
<tr>
<td>a. 375,000</td>
<td>334,000</td>
</tr>
<tr>
<td>b. 375,000</td>
<td>324,000</td>
</tr>
<tr>
<td>c. 334,000</td>
<td>334,000</td>
</tr>
<tr>
<td>d. 324,000</td>
<td>324,000</td>
</tr>
</tbody>
</table>

2. During 1990, Dale Corp. made the following accounting changes:

<table>
<thead>
<tr>
<th>Method used in 1989</th>
<th>Method used in 1990</th>
<th>After-tax effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sum-of-the-years' digits depreciation</td>
<td>Straight-line depreciation</td>
<td>$30,000</td>
</tr>
<tr>
<td>Weighted-average for inventory valuation</td>
<td>First-in, first-out for inventory valuation</td>
<td>98,000</td>
</tr>
</tbody>
</table>

What amount should be classified in 1990 as prior period adjustments?

a. $0
b. $ 30,000
c. $ 98,000
d. $128,000

3. Hoyt Corp.'s current balance sheet reports the following stockholders' equity:

5% cumulative preferred stock, par value $100 per share; 2,500 shares issued and outstanding $250,000

Common stock, par value $3.50 per share; 100,000 shares issued and outstanding 350,000

Additional paid-in capital in excess of par value of common stock 125,000

Retained earnings 300,000

Dividends in arrears on the preferred stock amount to $25,000. If Hoyt were to be liquidated, the preferred stockholders would receive par value plus a premium of $50,000. The book value per share of common stock is

a. $7.75
b. $7.50
c. $7.25
d. $7.00

4. At December 31, 1990, Salo Corp.'s balance sheet accounts increased by the following amounts compared with those at the end of the prior year:

<table>
<thead>
<tr>
<th>Assets</th>
<th>$178,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>54,000</td>
</tr>
<tr>
<td>Capital stock</td>
<td>120,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>12,000</td>
</tr>
</tbody>
</table>

The only charge to retained earnings during 1990 was for a dividend payment of $26,000. Net income for 1990 amounted to

a. $34,000
b. $26,000
c. $18,000
d. $ 8,000

5. Arp Corp.'s outstanding capital stock at December 15, 1990, consisted of the following:

- 30,000 shares of 5% cumulative preferred stock, par value $10 per share, fully participating as to dividends. No dividends were in arrears.
- 200,000 shares of common stock, par value $1 per share.

On December 15, 1990, Arp declared dividends of $100,000. What was the amount of dividends payable to Arp's common stockholders?

a. $10,000
b. $34,000
c. $40,000
d. $47,500
6. Ole Corp. declared and paid a liquidating dividend of $100,000. This distribution resulted in a decrease in Ole’s

<table>
<thead>
<tr>
<th>Paid-in capital</th>
<th>Retained earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

7. In 1989, Seda Corp. acquired 6,000 shares of its $1 par value common stock at $36 per share. During 1990, Seda issued 3,000 of these shares at $50 per share. Seda uses the cost method to account for its treasury stock transactions. What accounts and amounts should Seda credit in 1990 to record the issuance of the 3,000 shares?

<table>
<thead>
<tr>
<th>Treasury stock</th>
<th>Additional paid-in capital</th>
<th>Retained earnings</th>
<th>Common stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$102,000</td>
<td>$42,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>b.</td>
<td>$144,000</td>
<td>$42,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>c.</td>
<td>$108,000</td>
<td>$42,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>d.</td>
<td>$108,000</td>
<td>$42,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

8. Jay & Kay partnership’s balance sheet at December 31, 1990, reported the following:

- Total assets: $100,000
- Total liabilities: 20,000
- Jay, capital: 40,000
- Kay, capital: 40,000

On January 2, 1991, Jay and Kay dissolved their partnership and transferred all assets and liabilities to a newly-formed corporation. At the date of incorporation, the fair value of the net assets was $12,000 more than the carrying amount on the partnership’s books, of which $7,000 was assigned to tangible assets and $5,000 was assigned to goodwill. Jay and Kay were each issued 5,000 shares of the corporation’s $1 par value common stock. Immediately following incorporation, additional paid-in capital in excess of par should be credited for

- a. $68,000
- b. $70,000
- c. $77,000
- d. $82,000

9. Pine City owned a vacant plot of land zoned for industrial use. Pine gave this land to Medi Corp. solely as an incentive for Medi to build a factory on the site. The land had a fair value of $300,000 at the date of the gift. This non-monetary transaction should be reported by Medi as

- a. Extraordinary income.
- b. Additional paid-in capital.
- c. A credit to retained earnings.
- d. A memorandum entry.

10. Beni Corp. purchased 100% of Carr Corp.’s outstanding capital stock for $430,000 cash. Immediately before the purchase, the balance sheets of both corporations reported the following:

<table>
<thead>
<tr>
<th></th>
<th>Beni</th>
<th>Carr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$2,000,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$750,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>1,000,000</td>
<td>310,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>250,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Liabilities and stockholders’ equity</td>
<td>$2,000,000</td>
<td>$750,000</td>
</tr>
</tbody>
</table>

At the date of purchase, the fair value of Carr’s assets was $50,000 more than the aggregate carrying amounts. In the consolidated balance sheet prepared immediately after the purchase, the consolidated stockholders’ equity should amount to

- a. $1,680,000
- b. $1,650,000
- c. $1,600,000
- d. $1,250,000

11. The partnership agreement of Axel, Berg & Cobb provides for the year-end allocation of net income in the following order:

- First, Axel is to receive 10% of net income up to $100,000 and 20% over $100,000.
- Second, Berg and Cobb each are to receive 5% of the remaining income over $150,000.
- The balance of income is to be allocated equally among the three partners.

The partnership’s 1990 net income was $250,000 before any allocations to partners. What amount should be allocated to Axel?

- a. $101,000
- b. $103,000
- c. $108,000
- d. $110,000

12. Yola Corp., a diversified company, is required to report the operating profit or loss for each of its industry segments. For the year ended December 31, 1990, segment Wy’s sales to segment Zee were $100,000. Segment Wy’s share of Yola’s allocated general corporate expenses was $20,000. In the computation of Wy’s 1990 operating profit or loss, the amount of the aforementioned items to be included is

- a. $120,000
- b. $100,000
- c. $80,000
- d. $20,000

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13. Kell Corp.'s $95,000 net income for the quarter ended September 30, 1990, included the following after-tax items:

- A $60,000 extraordinary gain, realized on April 30, 1990, was allocated equally to the second, third, and fourth quarters of 1990.
- A $16,000 cumulative-effect loss resulting from a change in inventory valuation method was recognized on August 2, 1990.

In addition, Kell paid $48,000 on February 1, 1990, for 1990 calendar-year property taxes. Of this amount, $12,000 was allocated to the third quarter of 1990.

For the quarter ended September 30, 1990, Kell should report net income of

a. $ 91,000  
b. $103,000  
c. $111,000  
d. $115,000

14. Ely had the following personal investments at December 31, 1990:

- Realty held as a limited business activity not conducted in a separate business entity. Mortgage payments were made with funds from sources unrelated to the realty. The cost of this realty was $500,000, and the related mortgage payable was $100,000 at December 31, 1990.
- Sole proprietorship marketable as a going concern. Its cost was $900,000, and it had related accounts payable of $80,000 at December 31, 1990.

The costs of both investments equal estimated current values. The balances of liabilities equal their estimated current amounts.

How should the foregoing information be reported in Ely's statement of financial condition at December 31, 1990?

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Investment in real estate</td>
<td>$400,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>820,000</td>
</tr>
<tr>
<td>b. Investment in real estate</td>
<td>$500,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>820,000</td>
</tr>
<tr>
<td>c. Investment in real estate</td>
<td>$500,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>900,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>100,000</td>
</tr>
<tr>
<td>d. Investments</td>
<td>$1,400,000</td>
</tr>
<tr>
<td>Accounts and mortgage payable</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

15. At December 31, 1990, Ryan had the following non-cancelable personal commitments:

- Pledge to be paid to County Welfare Home 30 days after volunteers paint the walls and ceiling of the Home's recreation room $5,000
- Pledge to be paid to City Hospital on the recovery of Ryan's comatose sister 25,000

What amount should be included in liabilities in Ryan's personal statement of financial condition at December 31, 1990?

a. $0  
b. $5,000  
c. $25,000  
d. $30,000

16. The following information pertains to Smith's personal assets and liabilities at December 31, 1990:

<table>
<thead>
<tr>
<th>Historical cost</th>
<th>Estimated current values</th>
<th>Estimated current amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100,000</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Smith's 1990 income tax rate was 30%. In Smith's personal statement of financial condition at December 31, 1990, what amount should be reported as Smith's net worth?

a. $294,000  
b. $420,000  
c. $694,000  
d. $820,000

17. Mill Corp. acquired Vore Corp. in a business combination. At the acquisition date, Vore's plant and equipment had a carrying amount of $750,000 and a fair value of $875,000. What amount should the combined entity report for Vore's plant and equipment under each of the following methods at the date of acquisition?

<table>
<thead>
<tr>
<th>Pooling of interests</th>
<th>Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>$750,000</td>
</tr>
<tr>
<td>b.</td>
<td>$750,000</td>
</tr>
<tr>
<td>c.</td>
<td>$875,000</td>
</tr>
<tr>
<td>d.</td>
<td>$875,000</td>
</tr>
</tbody>
</table>

18. Tod Corp. wrote off $100,000 of obsolete inventory at December 31, 1990. The effect of this write-off was to decrease:

a. Both the current and acid-test ratios.  
b. Only the current ratio.  
c. Only the acid-test ratio.  
d. Neither the current nor the acid-test ratios.
19. Gil Corp. has current assets of $90,000 and current liabilities of $180,000. Which of the following transactions would improve Gil's current ratio?
   a. Refinancing a $30,000 long-term mortgage with a short-term note.
   b. Purchasing $50,000 of merchandise inventory with a short-term account payable.
   c. Paying $20,000 of short-term accounts payable.
   d. Collecting $10,000 of short-term accounts receivable.

20. Wall Corp.'s employee stock purchase plan specifies the following:
   • For every $1 withheld from employees' wages for the purchase of Wall's common stock, Wall contributes $2.
   • The stock is purchased from Wall's treasury stock at market price on the date of purchase.

The following information pertains to the plan's 1990 transactions:
   • Employee withholdings for the year $ 350,000
   • Market value of 150,000 shares issued 1,050,000
   • Carrying amount of treasury stock issued (cost) 900,000

Before payroll taxes, what amount should Wall recognize as expense in 1990 for the stock purchase plan?
   a. $1,050,000
   b. $ 900,000
   c. $ 700,000
   d. $ 550,000

22. Kent qualified for the earned income credit in 1990. This credit could result in a
   a. Refund even if Kent had no tax withheld from wages.
   b. Refund only if Kent had tax withheld from wages.
   c. Carryback or carryforward for any unused portion.
   d. Subtraction from adjusted gross income to arrive at taxable income.

23. The federal estate tax may be reduced by a credit for state
   a. Death taxes.
   b. Gift taxes on gifts made two years before death.
   c. Income taxes paid in the year of death.
   d. Intangible property taxes.

24. The 1990 standard deduction for a trust or an estate in the fiduciary income tax return is
   a. $0
   b. $650
   c. $750
   d. $800

25. Which of the following fiduciary entities are required to use the calendar year as their taxable period for income tax purposes?

<table>
<thead>
<tr>
<th>Estates</th>
<th>Trusts (except those that are tax exempt)</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>

26. During 1990, Blake transferred a corporate bond with a face amount and fair market value of $20,000 to a trust for the benefit of her 16-year old child. Annual interest on this bond is $2,000, which is to be accumulated in the trust and distributed to the child on reaching the age of 21. The bond is then to be distributed to the donor or her successor-in-interest in liquidation of the trust. Present value of the total interest to be received by the child is $8,710. The amount of the gift that is excludable from taxable gifts is
   a. $20,000
   b. $10,000
   c. $8,710
   d. $0

27. Within how many months after the date of a decedent's death is the federal estate tax return (Form 706) due if no extension of time for filing is granted?
   a. 9
   b. 6
   c. 4½
   d. 3½
Items 28 through 36 are based on the following:

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- The divorce agreement, executed in 1983, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 1990 in a suit to collect the alimony owed.
- In June 1990, Hall’s mother gifted her 100 shares of a listed stock. The donor’s basis for this stock, which she bought in 1970, was $4,000, and market value on the date of the gift was $3,000. Hall sold this stock in July 1990 for $3,500. The donor paid no gift tax.
- During 1990, Hall spent a total of $1,000 for state lottery tickets. Her lottery winnings totaled $200.
- Hall earned a salary of $25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed $2,000 to an IRA in 1990.
- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid $800 for the antique and sold it for $1,400, using the proceeds to pay a court-ordered judgment.
- Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, $3,400; mortgage interest, $7,000; casualty insurance, $490; assessment by city for construction of a sewer system, $910; interest of $1,000 on a personal, unsecured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

28. What amount should be reported in Hall’s 1990 return as alimony income?
   a. $36,000
   b. $28,800
   c. $5,000
   d. $0

29. The $2,000 legal fee that Hall paid to collect alimony should be treated as
   a. A deduction in arriving at adjusted gross income.
   b. An itemized deduction subject to the 2% of adjusted gross income floor.
   c. An itemized deduction not subject to the 2% of adjusted gross income floor.
   d. A nondeductible personal expense.

30. What was Hall’s reportable gain or loss in 1990 on the sale of the 100 shares of stock gifted to her?
   a. $0.
   b. $500 gain.
   c. $500 loss.
   d. $1,000 loss.

31. Hall’s lottery transactions should be reported as follows:

| Schedule A—Itemized Deductions |
|------------------------------|-----------------|----------------|
| Other income on page 1        | Subject to 2% AGI floor | Not subject to 2% AGI floor |
| a. $0                        | $0               | $0               |
| b. $200                      | $0               | $200             |
| c. $200                      | $200             | $0               |
| d. $200                      | $0               | $0               |

32. Hall’s $2,000 contribution to an IRA should be treated as
   a. An adjustment to income in arriving at adjusted gross income.
   b. A deduction from adjusted gross income subject to the 2% of adjusted gross income floor.
   c. A deduction from adjusted gross income not subject to the 2% of adjusted gross income floor.
   d. Nondeductible, with the interest income on the $2,000 to be deferred until withdrawal.

33. The $600 gain that Hall realized on the sale of the antique should be treated as
   a. Ordinary income.
   b. Long-term capital gain.
   c. An involuntary conversion.
   d. A nontaxable antiquities transaction.

34. What amount should be claimed in Hall’s 1990 return as an itemized deduction for interest?
   a. $7,000
   b. $7,100
   c. $7,200
   d. $8,000

35. The $910 sewer system assessment imposed by the city in 1990 is
   a. Allowed with the realty taxes as an itemized deduction for taxes.
   b. Allowed as an itemized deduction subject to the 2% of adjusted gross income floor.
   c. Deductible in arriving at adjusted gross income.
36. The casualty insurance premium of $490 is
   a. Allowed as an itemized deduction subject to the $100 floor and the 10% of adjusted gross income floor.
   b. Allowed as an itemized deduction subject to the 2% of gross income floor.
   c. Deductible in arriving at adjusted gross income.

37. Under the unified rate schedule,
   a. Lifetime taxable gifts are taxed on a noncumulative basis.
   b. Transfers at death are taxed on a noncumulative basis.
   c. Lifetime taxable gifts and transfers at death are taxed on a cumulative basis.
   d. The gift tax rates are 5% higher than the estate tax rates.

38. The generation-skipping transfer tax is imposed
   a. Instead of the gift tax.
   b. Instead of the estate tax.
   c. As a separate tax in addition to the gift and estate taxes.
   d. On transfers of future interest to beneficiaries who are more than one generation above the donor’s generation.

39. Ordinary and necessary administration expenses paid by the fiduciary of an estate are deductible
   a. Only on the fiduciary income tax return (Form 1041) and never on the federal estate tax return (Form 706).
   b. Only on the federal estate tax return and never on the fiduciary income tax return.
   c. On the fiduciary income tax return only if the estate tax deduction is waived for these expenses.
   d. On both the fiduciary income tax return and on the estate tax return by adding a tax computed on the proportionate rates attributable to both returns.

40. Which of the following requires filing a gift tax return, if the transfer exceeds the available annual gift tax exclusion?
   a. Medical expenses paid directly to a physician on behalf of an individual unrelated to the donor.
   b. Tuition paid directly to an accredited university on behalf of an individual unrelated to the donor.
   c. Payments for college books, supplies, and dormitory fees on behalf of an individual unrelated to the donor.
   d. Campaign expenses paid to a political organization.

Number 3 (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.

41. A corporation’s capital loss carryback or carryover is
   a. Not allowable under current law.
   b. Limited to $3,000.
   c. Always treated as a long-term capital loss.
   d. Always treated as a short-term capital loss.

42. Lyle Corp. is a distributor of pharmaceuticals and sells only to retail drug stores. During 1990, Lyle received unsolicited samples of nonprescription drugs from a manufacturer. Lyle donated these drugs in 1990 to a qualified exempt organization and deducted their fair market value as a charitable contribution. What should be included as gross income in Lyle’s 1990 return for receipt of these samples?
   a. Fair market value.
   b. Net discounted wholesale price.
   c. $25 nominal value assigned to gifts.
   d. $0

43. Which of the following entities must include in gross income 100% of dividends received from unrelated taxable domestic corporations in computing regular taxable income?

<table>
<thead>
<tr>
<th>Personal service corporations</th>
<th>Personal holding companies</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>

44. Andi Corp. issued $1,000,000 face amount of bonds in 1985 and established a sinking fund to pay the debt at maturity. The bondholders appointed an independent trustee to invest the sinking fund contributions and to administer the trust. In 1990, the sinking fund earned $60,000 in interest on bank deposits and $8,000 in net long-term capital gains. All of the trust income is accumulated with Andi’s periodic contributions so that the aggregate amount will be sufficient to pay the bonds when they mature. What amount of trust income was taxable to Andi in 1990?
   a. $0
   b. $8,000
   c. $60,000
   d. $68,000
45. Par Corp. acquired the assets of its wholly owned subsidiary, Sub Corp., under a plan that qualified as a tax-free complete liquidation of Sub. Which of the following of Sub's unused carryovers may be transferred to Par?

<table>
<thead>
<tr>
<th>Excess charitable contributions</th>
<th>Net operating loss</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. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

46. In a C corporation's computation of the maximum allowable deduction for contributions, what percentage limitation should be applied to the applicable base amount?

a. 5%

b. 10%

c. 30%

d. 50%

47. In the case of a corporation that is not a financial institution, which of the following statements is correct with regard to the deduction for bad debts?

a. Either the reserve method or the direct charge-off method may be used, if the election is made in the corporation's first taxable year.

b. On approval from the IRS, a corporation may change its method from direct charge-off to reserve.

c. If the reserve method was consistently used in prior years, the corporation may take a deduction for a reasonable addition to the reserve for bad debts.

d. A corporation is required to use the direct charge-off method rather than the reserve method.

48. The costs of organizing a corporation

a. May be deducted in full in the year in which these costs are incurred even if paid in later years.

b. May be deducted only in the year in which these costs are paid.

c. May be amortized over a period of not less than 60 months even if these costs are capitalized on the company's books.

d. Are nondeductible capital expenditures.

49. Would the following expense items be reported on Schedule M-1 of the corporation income tax return showing the reconciliation of income per books with income per return?

<table>
<thead>
<tr>
<th>Interest incurred on loan to carry U.S. obligations</th>
<th>Provision for state corporation income tax</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>

50. Page Corp. owns 80% of Saga Corp.'s outstanding capital stock. Saga's capital stock consists of 50,000 shares of common stock issued and outstanding. Saga's 1990 net income was $70,000. During 1990, Saga declared and paid dividends of $30,000. In conformity with generally accepted accounting principles, Page recorded the following entries in 1990:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Saga Corp. common stock</td>
<td>$56,000</td>
</tr>
<tr>
<td>Equity in earnings of subsidiary</td>
<td>$56,000</td>
</tr>
<tr>
<td>Cash</td>
<td>24,000</td>
</tr>
<tr>
<td>Investment in Saga Corp. common stock</td>
<td>24,000</td>
</tr>
</tbody>
</table>

In its 1990 consolidated tax return, Page should report dividend revenue of

a. $0

b. $4,800

c. $7,200

d. $24,000

51. No penalty will be imposed on a corporation for underpayment of estimated tax for a particular year if

a. The tax for that year is less than $500.

b. Estimated tax payments for the year equal at least 80% of the tax shown on the return for that year.

c. The corporation is a personal holding company.

d. The alternative minimum tax is at least $1,000.

52. The following information pertains to Wald Corp.'s operations for the year ended December 31, 1990:

| Worldwide taxable income | $300,000 |
| U.S. source taxable income | 180,000 |
| U.S. income tax before foreign tax credit | 96,000 |
| Foreign nonbusiness-related interest earned | 30,000 |
| Foreign income taxes paid on nonbusiness-related interest earned | 12,000 |
| Other foreign source taxable income | 90,000 |
| Foreign income taxes paid on other foreign source taxable income | 27,000 |

What amount of foreign tax credit may Wald claim for 1990?

a. $28,800

b. $36,600

c. $38,400

d. $39,000
53. Which of the following exempt organizations must file annual information returns?
   a. Those with gross receipts of less than $5,000 in each taxable year.
   b. Private foundations.
   c. Internally supported auxiliaries of churches.
   d. Churches.

54. The basis to a partner of property distributed "in kind" in complete liquidation of the partner's interest is the
   a. Adjusted basis of the partner's interest increased by any cash distributed to the partner in the same transaction.
   b. Adjusted basis of the partner's interest reduced by any cash distributed to the partner in the same transaction.
   c. Adjusted basis of the property to the partnership.
   d. Fair market value of the property.

55. Which of the following limitations will apply in determining a partner's deduction for that partner's share of partnership losses?

<table>
<thead>
<tr>
<th></th>
<th>At-risk</th>
<th>Passive loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Yes</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>No</td>
<td>No</td>
</tr>
</tbody>
</table>

56. Ola Associates is a limited partnership engaged in real estate development. Hoff, a civil engineer, billed Ola $40,000 in 1990 for consulting services rendered. In full settlement of this invoice, Hoff accepted a $15,000 cash payment plus the following:

<table>
<thead>
<tr>
<th>Fair market value</th>
<th>Carrying amount on Ola's books</th>
</tr>
</thead>
<tbody>
<tr>
<td>3% limited partnership interest in Ola</td>
<td>$10,000</td>
</tr>
<tr>
<td>Surveying equipment</td>
<td>$7,000</td>
</tr>
</tbody>
</table>

What amount should Hoff, a cash-basis taxpayer, report in his 1990 return as income for the services rendered to Ola?
   a. $15,000
   b. $28,000
   c. $32,000
   d. $40,000

57. A corporation that has been an S corporation from its inception may

<table>
<thead>
<tr>
<th>Have both passive and nonpassive income</th>
<th>Be owned by a bankruptcy estate</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. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

58. The following information pertains to property contributed by Gray on July 1, 1990, for a 40% interest in the capital and profits of Kag & Gray, a partnership:

<table>
<thead>
<tr>
<th>Adjusted basis</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>As of June 30, 1990</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

After Gray's contribution, Kag & Gray's capital totaled $150,000. What amount of gain was reportable in Gray's 1990 return on the contribution of property to the partnership?
   a. $0
   b. $6,000
   c. $30,000
   d. $36,000

59. Which of the following should be used in computing the basis of a partner's interest acquired from another partner?

<table>
<thead>
<tr>
<th>Cash paid by transferee to transferee</th>
<th>Transferee's share of partnership liabilities</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. No</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

60. The holding period of a partnership interest acquired in exchange for a contributed capital asset begins on the date
   a. The partner is admitted to the partnership.
   b. The partner transfers the asset to the partnership.
   c. The partner's holding period of the capital asset began.
   d. The partner is first credited with the proportionate share of partnership capital.

Question Number 4 is on Page N-24
Number 4 (Estimated time — 45 to 55 minutes)

Tredoc Co. is engaged in the business of seasonal tree-spraying and uses chemicals in its operations to prevent disease and bug-infestation. Employees are guaranteed 165 hours of work per month at $8 per hour and receive a bonus equal to 75% of their net favorable direct labor efficiency variance. The efficiency variance represents the difference between actual time consumed in spraying a tree and the standard time allowed for the height of the tree (specified in feet), multiplied by the $8 standard hourly wage rate. For budgeting purposes, there is a standard allowance of one hour per customer for travel, setup, and clearup time. However, since several factors are uncontrollable by the employee, this one-hour budget allowance is excluded from the bonus calculation. Employees are responsible for keeping their own daily time-cards.

Chemical usage should vary directly with the tree-footage sprayed. Variable overhead includes costs that vary directly with the number of customers, as well as costs that vary according to tree-footage sprayed. Customers pay a service charge of $10 per visit and $1 per tree-foot sprayed.

The standard static budget and actual results for June are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Static budget</th>
<th>Actual results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service calls (200 customers)</td>
<td>$2,000</td>
<td>$2,100</td>
</tr>
<tr>
<td>Footage sprayed (18,000 feet)</td>
<td>18,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Total revenues</td>
<td>20,000</td>
<td>23,100</td>
</tr>
<tr>
<td>Chemicals (1,800 gallons)</td>
<td>4,500</td>
<td>5,880</td>
</tr>
<tr>
<td>Direct labor:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel, setup, and clearup</td>
<td>$1,600</td>
<td>$2,400</td>
</tr>
<tr>
<td>Tree-spraying</td>
<td>7,200</td>
<td>7,280</td>
</tr>
<tr>
<td>Total direct labor</td>
<td>8,800</td>
<td>9,680</td>
</tr>
<tr>
<td>Overhead:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable based on number of customers</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Variable based on tree-footage</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Total overhead</td>
<td>5,000</td>
<td>5,400</td>
</tr>
<tr>
<td>Total costs</td>
<td>18,300</td>
<td>20,960</td>
</tr>
<tr>
<td>Gross profit before bonus</td>
<td>$1,700</td>
<td>$2,140</td>
</tr>
</tbody>
</table>

July's demand is expected to be in excess of June's and may be met by either paying a 25% overtime premium to current employees or by hiring an additional employee. A new employee will cause fixed costs to increase by $100 per month. The potential increased demand may be estimated by considering the impact of increases of 20 and 30 customers, with probabilities of 70% and 30%, respectively.

**Required:**

a. Compute the following for June:
   1. Direct materials price variance.
   2. Direct materials usage (efficiency) variance.
   3. Direct labor travel, setup, and clearup variance.
   4. Direct labor bonus.
   5. Overhead spending (flexible budget) variance.

Indicate whether each variance is favorable or unfavorable.

b. Assume that Tredoc accepts all orders for services in July. Should Tredoc hire an additional employee? Provide supporting computations based on standard cost.
The following information pertains to Eden Township's construction and financing of a new administration center:

Estimated total cost of project $9,000,000

Project financing:
- State entitlement grant 3,000,000
- General obligation bonds:
  - Face amount 6,000,000
  - Stated interest rate 6%
  - Issue date December 1, 1990
  - Maturity date November 30, 2000

During Eden's year ended June 30, 1991, the following events occurred that affect the capital projects fund established to account for this project:

July 1, 1990 — The capital projects fund borrowed $300,000 from the general fund for preliminary expenses.

July 9, 1990 — Engineering and planning costs of $200,000, for which no encumbrance had been recorded, were paid to Napp Associates.

December 1, 1990 — The bonds were sold at 101. Total proceeds were retained by the capital projects fund.

December 1, 1990 — The entitlement grant was formally approved by the state.

April 30, 1991 — A $7,000,000 contract was executed with Caro Construction Corp., the general contractors, for the major portion of the project. The contract provides that Eden will withhold 4% of all billings pending satisfactory completion of the project.

May 9, 1991 — $1,000,000 of the state grant was received.

June 10, 1991 — The $300,000 borrowed from the general fund was repaid.

June 30, 1991 — Progress billing of $1,200,000 was received from Caro.

Eden uses encumbrance accounting for budgetary control. Unencumbered appropriations lapse at the end of the year.

Required:

a. Prepare journal entries in the administration center capital projects fund to record the foregoing transactions.

b. Prepare the June 30, 1991, closing entries for the administration center capital projects fund.

EXAMINATION IN AUDITING

November 7, 1991; 8:30 A.M. to 12:00 Noon

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

<table>
<thead>
<tr>
<th>No.</th>
<th>Point Value</th>
<th>Estimated Minutes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>60</td>
<td>Minimum 90</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>Maximum 110</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
<td>Minimum 15</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>Maximum 25</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>Minimum 15</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Maximum 25</td>
</tr>
<tr>
<td></td>
<td>Totals</td>
<td>100</td>
</tr>
</tbody>
</table>

INSTRUCTIONS TO CANDIDATES

Failure to follow these instructions may have an adverse effect on your examination grade.

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 multiple-choice answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all multiple-choice items on the printed multiple-choice answer sheet. You should attempt to answer all multiple-choice items. There is no penalty for incorrect responses. Since the multiple-choice items are computer-graded, your comments and calculations associated with them are not considered and should not be submitted. Be certain that you have entered your answers on the multiple-choice answer sheet before the examination time is up. The multiple-choice portion of your examination will not be graded if you fail to record your answers on the multiple-choice answer sheet.

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 candidates' 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.

4. Write your 7-digit candidate number in the space provided at the upper right-hand corner of this page.

5. You must hand in your examination question booklet, multiple-choice answer sheet, and green essay answer worksheets. Your examination will not be graded unless your examination question booklet, multiple-choice answer sheet, and green essay answer worksheets are handed in before leaving the examination room.

6. If you want your examination question booklet mailed to you, write your name and address on the back cover, and place 52 cents postage in the space provided, unless otherwise instructed. Also, unless instructed otherwise, write your name and address in the return address space in the upper left-hand corner on the back cover. Examination question booklets will be distributed no sooner than the day following the administration of this examination, unless instructed otherwise.

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.
**Auditing**

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 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. Exercise due professional care in performing the audit.

d. Count client petty cash funds.

**Answer Sheet**

96. a. b. c. d.

1. A CPA firm would be reasonably assured of meeting its responsibility to provide services that conform with professional standards by

a. Adhering to generally accepted auditing standards.

b. Having an appropriate system of quality control.

c. Joining professional societies that enforce ethical conduct.

d. Maintaining an attitude of independence in its engagements.

2. A violation of the profession’s ethical standards least likely would have occurred when a CPA

a. Purchased another CPA’s accounting practice and based the price on a percentage of the fees accruing from clients over a three-year period.

b. Received a percentage of the amounts invested by the CPA’s audit clients in a tax shelter with the clients’ knowledge and approval.

c. Had a public accounting practice and also was president and sole stockholder of a corporation that engaged in data processing services for the public.

d. Formed an association — not a partnership — with two other sole practitioners and called the association “Adams, Betts and Associates.”

3. Which of the following procedures would an auditor most likely perform in planning a financial statement audit?

a. Reviewing investment transactions of the audit period to determine whether related parties were created.

b. Performing analytical procedures to identify areas that may represent specific risks.

c. Reading the minutes of stockholder and director meetings to discover whether any unusual transactions have occurred.

d. Obtaining a written representation letter from the client to emphasize management’s responsibilities.

4. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding

a. Disagreements the predecessor had with the client concerning auditing procedures and accounting principles.

b. The predecessor’s evaluation of matters of continuing accounting significance.

c. The degree of cooperation the predecessor received concerning the inquiry of the client’s lawyer.

d. The predecessor’s assessments of inherent risk and judgments about materiality.

5. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the

a. Audit has been performed by persons having adequate technical training and proficiency as auditors.

b. Auditor’s system of quality control has been maintained at a high level.

c. Results are consistent with the conclusions to be presented in the auditor’s report.

d. Audit procedures performed are approved in the professional standards.

6. The existence of audit risk is recognized by the statement in the auditor’s standard report that the auditor

a. Obtains reasonable assurance about whether the financial statements are free of material misstatement.

b. Assesses the accounting principles used and also evaluates the overall financial statement presentation.

c. Realizes some matters, either individually or in the aggregate, are important while other matters are not important.

d. Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.
7. The risk that an auditor will conclude, based on substantive tests, that a material error does not exist in an account balance when, in fact, such error does exist is referred to as
   a. Sampling risk.
   b. Detection risk.
   c. Nonsampling risk.
   d. Inherent risk.

8. In developing a preliminary audit strategy, an auditor should consider
   a. Whether the allowance for sampling risk exceeds the achieved upper precision limit.
   b. Findings from substantive tests performed at interim dates.
   c. Whether the inquiry of the client’s attorney identifies any litigation, claims, or assessments not disclosed in the financial statements.
   d. The planned assessed level of control risk.

9. Which of the following best describes what is meant by the term generally accepted auditing standards?
   a. Procedures to be used to gather evidence to support financial statements.
   b. Measures of the quality of the auditor’s performance.
   c. Pronouncements issued by the Auditing Standards Board.
   d. Rules acknowledged by the accounting profession because of their universal application.

10. Which of the following statements describes why a properly designed and executed audit may not detect a material irregularity?
    a. Audit procedures that are effective for detecting an unintentional misstatement may be ineffective for an intentional misstatement that is concealed through collusion.
    b. An audit is designed to provide reasonable assurance of detecting material errors, but there is no similar responsibility concerning material irregularities.
    c. The factors considered in assessing control risk indicated an increased risk of intentional misstatements, but only a low risk of unintentional errors in the financial statements.
    d. The auditor did not consider factors influencing audit risk for account balances that have effects pervasive to the financial statements taken as a whole.

11. When an auditor becomes aware of a possible client illegal act, the auditor should obtain an understanding of the nature of the act to
    a. Increase the assessed level of control risk.
    b. Recommend remedial actions to the audit committee.
    c. Evaluate the effect on the financial statements.
    d. Determine the reliability of management’s representations.

12. Which of the following circumstances most likely would cause an auditor to consider whether material misstatements exist in an entity’s financial statements?
    a. Supporting records that should be readily available are frequently not produced when requested.
    b. Reportable conditions previously communicated have not been corrected.
    c. Clerical errors are listed on a monthly computer-generated exception report.
    d. Differences are discovered during the client’s annual physical inventory count.

13. Statements on Standards for Accounting and Review Services establish standards and procedures for which of the following engagements?
    a. Assisting in adjusting the books of account for a partnership.
    b. Reviewing interim financial data required to be filed with the SEC.
    c. Processing financial data for clients of other accounting firms.
    d. Compiling an individual’s personal financial statement to be used to obtain a mortgage.

14. Which of the following general standards apply to MAS engagements and consultations?

<table>
<thead>
<tr>
<th>Due professional care</th>
<th>Independence in mental attitude</th>
<th>Planning and supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

15. Which of the following statements is correct concerning a CPA’s responsibility when the CPA uses taxpayer estimates in preparing a tax return?
    a. Tax preparation requires the CPA to exercise judgment, but prohibits the CPA’s use of estimates and approximations.
    b. Use of taxpayer estimates in a tax return is prohibited unless they are specifically disclosed by the CPA.
    c. When all facts relating to a transaction are not accurately known because records are missing, reasonable estimates made by the taxpayer of the missing data may be used by the CPA.
    d. The CPA may prepare tax returns involving the use of taxpayer estimates even if it is practical to obtain exact data.
16. An auditor may reasonably issue an “except for” qualified opinion for an entity when auditing financial statements that are prescribed in a regulatory basis prescribed by a regulatory agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a
   a. Qualified opinion.
   b. Standard three paragraph report with reference to footnote disclosure.
   c. Disclaimer of opinion.
   d. Special report.

17. Helpful Co., a nonprofit entity, prepared its financial statements on an accounting basis prescribed by a regulatory agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a
   a. Qualified opinion.
   b. Standard three paragraph report with reference to footnote disclosure.
   c. Disclaimer of opinion.
   d. Special report.

18. The following explanatory paragraph was included in an auditor’s report to indicate a lack of consistency:

   “As discussed in note T to the financial statements, the company changed its method of computing depreciation in 1990.”

How should the auditor report on this matter if the auditor concurred with the change?

<table>
<thead>
<tr>
<th>Type of opinion</th>
<th>Location of explanatory paragraph</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Unqualified</td>
<td>Before opinion paragraph</td>
</tr>
<tr>
<td>b. Unqualified</td>
<td>After opinion paragraph</td>
</tr>
<tr>
<td>c. Qualified</td>
<td>Before opinion paragraph</td>
</tr>
<tr>
<td>d. Qualified</td>
<td>After opinion paragraph</td>
</tr>
</tbody>
</table>

19. When an auditor concludes there is substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time, the auditor’s responsibility is to
   a. Prepare prospective financial information to verify whether management’s plans can be effectively implemented.
   b. Project future conditions and events for a period of time not to exceed one year following the date of the financial statements.
   c. Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
   d. Consider the adequacy of disclosure about the entity’s possible inability to continue as a going concern.

20. After issuing a report, an auditor has no obligation to make continuing inquiries or perform other procedures concerning the audited financial statements, unless
   a. Information, which existed at the report date and may affect the report, comes to the auditor’s attention.
   b. Management of the entity requests the auditor to reissue the auditor’s report.
   c. Information about an event that occurred after the end of field work comes to the auditor’s attention.
   d. Final determinations or resolutions are made of contingencies that had been disclosed in the financial statements.

21. How does an auditor make the following representations when issuing the standard auditor’s report on comparative financial statements?

<table>
<thead>
<tr>
<th>Examination of evidence on a test basis</th>
<th>Consistent application of accounting principles</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>

22. An auditor was unable to obtain sufficient competent evidential matter concerning certain transactions due to an inadequacy in the entity’s accounting records. The auditor would choose between issuing an opinion
   a. Qualified opinion and an unqualified opinion with an explanatory paragraph.
   b. Unqualified opinion with an explanatory paragraph and an adverse opinion.
   c. Adverse opinion and a disclaimer of opinion.
   d. Disclaimer of opinion and a qualified opinion.

23. For an entity’s financial statements to be presented fairly in conformity with generally accepted accounting principles, the principles selected should
   a. Be applied on a basis consistent with those followed in the prior year.
   b. Be approved by the Auditing Standards Board or the appropriate industry subcommittee.
   c. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
   d. Match the principles used by most other entities within the entity’s particular industry.

24. Which of the following is not a major reason for maintaining an audit trail for a computer system?
   a. Deterrent to irregularities.
   b. Monitoring purposes.
   c. Analytical procedures.
   d. Query answering.
25. Financial statements of a nonpublic entity that have been reviewed by an accountant should be accompanied by a report stating that
   a. The scope of the inquiry and analytical procedures performed by the accountant has not been restricted.
   b. All information included in the financial statements is the representation of the management of the entity.
   c. A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
   d. A review is greater in scope than a compilation, the objective of which is to present financial statements that are free of material misstatements.

26. How does an accountant make the following representations when issuing the standard report for the compilation of a nonpublic entity's financial statements?

<table>
<thead>
<tr>
<th>The financial statements have not been audited</th>
<th>The accountant has compiled the financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Implicitly</td>
<td>Implicitly</td>
</tr>
<tr>
<td>b. Explicitly</td>
<td>Explicitly</td>
</tr>
<tr>
<td>c. Implicitly</td>
<td>Explicitly</td>
</tr>
<tr>
<td>d. Explicitly</td>
<td>Implicitly</td>
</tr>
</tbody>
</table>

27. The objective of a review of interim financial information of a public entity is to provide the accountant with a basis for
   a. Determining whether the prospective financial information is based on reasonable assumptions.
   b. Expressing a limited opinion that the financial information is presented in conformity with generally accepted accounting principles.
   c. Deciding whether to perform substantive audit procedures prior to the balance sheet date.
   d. Reporting whether material modifications should be made for such information to conform with generally accepted accounting principles.

28. Miller Co. uses the first-in, first-out method of costing for its international subsidiary’s inventory and the last-in, first-out method of costing for its domestic inventory. Under these circumstances, Miller should issue an auditor’s report with an
   a. "Except for" qualified opinion.
   b. Unqualified opinion.
   c. Explanatory paragraph as to consistency.
   d. Opinion modified as to consistency.

29. An auditor may report on condensed financial statements that are derived from complete audited financial statements if the
   a. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects.
   b. Condensed financial statements are presented in comparative form with the prior year’s condensed financial statements.
   c. Auditor describes the additional review procedures performed on the condensed financial statements.
   d. Condensed financial statements are distributed only to management and the board of directors.

30. In which of the following situations would a principal auditor least likely make reference to another auditor who audited a subsidiary of the entity?
   a. The other auditor was retained by the principal auditor and the work was performed under the principal auditor’s guidance and control.
   b. The principal auditor finds it impracticable to review the other auditor’s work or otherwise be satisfied as to the other auditor’s work.
   c. The financial statements audited by the other auditor are material to the consolidated financial statements covered by the principal auditor’s opinion.
   d. The principal auditor is unable to be satisfied as to the independence and professional reputation of the other auditor.

31. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may include in the auditor’s report on the financial statements an opinion that the accompanying information is fairly stated in
   a. Conformity with standards established by the AICPA.
   b. Accordance with generally accepted auditing standards.
   c. Conformity with generally accepted accounting principles.
   d. All material respects in relation to the basic financial statements taken as a whole.

32. Which of the following is a general control that would most likely assist an entity whose systems analyst left the entity in the middle of a major project?
   a. Grandfather-father-son record retention.
   b. Input and output validation routines.
   c. Systems documentation.
   d. Check digit verification.
33. Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?
   a. Random error associated with processing similar transactions in different ways is usually greater.
   b. It is usually more difficult to compare recorded accountability with physical count of assets.
   c. Attention is focused on the accuracy of the programming process rather than errors in individual transactions.
   d. It is usually easier for unauthorized persons to access and alter the files.

34. After obtaining an understanding of the internal control structure and assessing control risk of an entity, an auditor decided _not_ to perform tests of controls. The auditor most likely decided that
   a. The available evidential matter obtained through tests of controls would not support an increased level of control risk.
   b. A reduction in the assessed level of control risk is justified for certain financial statement assertions.
   c. It would be inefficient to perform tests of controls that would result in a reduction in planned substantive tests.
   d. The assessed level of inherent risk exceeded the assessed level of control risk.

35. An auditor would most likely be concerned with internal control structure policies and procedures that provide reasonable assurance about the
   a. Efficiency of management's decision-making process.
   b. Appropriate prices the entity should charge for its products.
   c. Methods of assigning production tasks to employees.
   d. Entity's ability to process and summarize financial data.

36. Which of the following most likely represents a significant deficiency in the internal control structure?
   a. The systems analyst reviews applications of data processing and maintains systems documentation.
   b. The systems programmer designs systems for computerized applications and maintains output controls.
   c. The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.
   d. The accounts payable clerk prepares data for computer processing and enters the data into the computer.

37. As the acceptable level of detection risk decreases, the assurance directly provided from
   a. Substantive tests should increase.
   b. Substantive tests should decrease.
   c. Tests of controls should increase.
   d. Tests of controls should decrease.

38. Mailing disbursement checks and remittance advices should be controlled by the employee who
   a. Approves the vouchers for payment.
   b. Matches the receiving reports, purchase orders, and vendors' invoices.
   c. Maintains possession of the mechanical check-signing device.
   d. Signs the checks last.

39. The safeguarding of inventory most likely includes
   a. Comparison of the information contained on the purchase requisitions, purchase orders, receiving reports, and vendors' invoices.
   b. Periodic reconciliation of detailed inventory records with the actual inventory on hand by taking a physical count.
   c. Analytical procedures for raw materials, goods in process, and finished goods that identify unusual transactions, theft, and obsolescence.
   d. Application of established overhead rates on the basis of direct labor hours or direct labor costs.

40. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the
   a. Authorization of transactions from the custody of related assets.
   b. Operational responsibility from the record keeping responsibility.
   c. Human resources function from the controllership function.
   d. Administrative controls from the internal accounting controls.

41. Immediately upon receipt of cash, a responsible employee should
   a. Record the amount in the cash receipts journal.
   b. Prepare a remittance listing.
   c. Update the subsidiary accounts receivable records.
   d. Prepare a deposit slip in triplicate.

42. Which of the following statements concerning analytical procedures is correct?
   a. Analytical procedures may be omitted entirely for some financial statement audits.
   b. Analytical procedures used in planning the audit should not use nonfinancial information.
   c. Analytical procedures usually are effective and efficient for tests of controls.
   d. Analytical procedures alone may provide the appropriate level of assurance for some assertions.
43. Which of the following statements is correct concerning reportable conditions noted in an audit?
   a. Reportable conditions are material weaknesses in the design or operation of specific internal control structure elements.
   b. The auditor is obligated to search for reportable conditions that could adversely affect the entity's ability to record and report financial data.
   c. Reportable conditions should be communicated each year, even if management has acknowledged its understanding of such deficiencies.
   d. The auditor may separately communicate those reportable conditions considered to be material weaknesses.

44. To satisfy the valuation assertion when auditing an investment accounted for by the equity method, an auditor most likely would
   a. Inspect the stock certificates evidencing the investment.
   b. Examine the audited financial statements of the investee company.
   c. Review the broker's advice or canceled check for the investment's acquisition.
   d. Obtain market quotations from financial newspapers or periodicals.

45. Cutoff tests designed to detect credit sales made before the end of the year that have been recorded in the subsequent year provide assurance about management's assertion of
   a. Presentation.
   b. Completeness.
   c. Rights.
   d. Existence.

46. Inquiries of warehouse personnel concerning possible obsolete or slow-moving inventory items provide assurance about management's assertion of
   a. Completeness.
   b. Existence.
   c. Presentation.
   d. Valuation.

47. The objective of tests of details of transactions performed as substantive tests is to
   a. Detect material misstatements in the financial statements.
   b. Evaluate whether management's policies and procedures operated effectively.
   c. Identify specific financial statement assertions that satisfy the audit objectives.
   d. Verify that significant deficiencies in the accounting system are discovered.

48. An auditor's analytical procedures most likely would be facilitated if the entity
   a. Corrects material weaknesses in internal control before the beginning of the audit.
   b. Develops its data from sources solely within the entity.
   c. Segregates obsolete inventory before the physical inventory count.
   d. Uses a standard cost system that produces variance reports.

49. If the objective of a test of details is to detect overstatements of sales, the auditor should trace transactions from the
   a. Cash receipts journal to the sales journal.
   b. Sales journal to the cash receipts journal.
   c. Source documents to the accounting records.
   d. Accounting records to the source documents.

50. When searching for unrecorded liabilities at year end, an auditor most likely would examine
   a. Cash receipts from related parties recorded before year end.
   b. Confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
   c. Cash disbursements recorded in the period subsequent to year end.
   d. Invoices dated a few days before and after year end to ascertain whether they have been properly recorded.

51. Which of the following procedures most likely would justify the use of the negative form of accounts receivable confirmation?
   a. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
   b. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.
   c. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
   d. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.

52. The audit working paper that reflects the major components of an amount reported in the financial statements is
   a. Interbank transfer schedule.
   b. Carryforward schedule.
   c. Supporting schedule.
   d. Lead schedule.
53. Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?
   a. A written engagement letter formalizing the level of service to be rendered.
   b. A flowchart depicting the segregation of duties and authorization of transactions.
   c. A written audit program describing the necessary procedures to be performed.
   d. A memorandum setting forth the scope of the audit.

54. An auditor should trace bank transfers for the last part of the audit period and first part of the subsequent period to detect whether
   a. The cash receipts journal was held open for a few days after the year end.
   b. The last checks recorded before the year end were actually mailed by the year end.
   c. Cash balances were overstated because of kiting.
   d. Any unusual payments to or receipts from related parties occurred.

55. To obtain evidence that user identification and password controls are functioning as designed, an auditor would most likely
   a. Review the online transaction log to ascertain whether employees using passwords have access to data files and computer programs.
   b. Examine a sample of assigned passwords and access authority to determine whether password holders have access authority incompatible with their other responsibilities.
   c. Extract a random sample of processed transactions and ensure that transactions are appropriately authorized.
   d. Observe the file librarian's activities to discover whether other systems personnel are permitted to operate computer equipment without restriction.

56. After identifying related party transactions, an auditor most likely would
   a. Substantiate that the transactions were consummated on terms equivalent to those prevailing in arms-length transactions.
   b. Discuss the implications of the transactions with third parties, such as the entity’s attorneys and bankers.
   c. Determine whether the transactions were approved by the board of directors or other appropriate officials.
   d. Ascertain whether the transactions would have occurred if the parties had not been related.

57. An auditor issued an audit report that was dual dated for a subsequent event occurring after the completion of field work but before issuance of the auditor’s report. The auditor’s responsibility for events occurring subsequent to the completion of field work was
   a. Extended to subsequent events occurring through the date of issuance of the report.
   b. Extended to include all events occurring since the completion of field work.
   c. Limited to the specific event referenced.
   d. Limited to include only events occurring up to the date of the last subsequent event referenced.

58. When providing limited assurance that the financial statements of a nonpublic entity require no material modifications to be in accordance with generally accepted accounting principles, the accountant should
   a. Understand the accounting principles of the industry in which the entity operates.
   b. Develop audit programs to determine whether the entity’s financial statements are fairly presented.
   c. Assess the risk that a material misstatement could occur in a financial statement assertion.
   d. Confirm with the entity’s lawyer that material loss contingencies are disclosed.

59. Which of the following statements is correct concerning both an engagement to compile and an engagement to review a nonpublic entity’s financial statements?
   a. The accountant does not contemplate obtaining an understanding of the internal control structure.
   b. The accountant must be independent in fact and appearance.
   c. The accountant expresses no assurance on the financial statements.
   d. The accountant should obtain a written management representation letter.

60. Which of the following is not an audit procedure that the independent auditor would perform concerning litigation, claims, and assessments?
   a. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
   b. Confirm directly with the client’s lawyer that all claims have been recorded in the financial statements.
   c. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
   d. Obtain from management a description and evaluation of litigation, claims, and assessments existing at the balance sheet date.
Number 2 (Estimated time — 15 to 25 minutes)

Toxic Waste Disposal Co., Inc. (TWD) is a not-for-profit organization that receives grants and fees from various state and municipal governments as well as grants from several federal government agencies.

TWD engaged Hall & Hall, CPAs, to audit its financial statements for the year ended July 31, 1991, in accordance with Government Auditing Standards. Accordingly, the auditors’ reports are to be submitted by TWD to the granting government agencies, which make the reports available for public inspection.

The auditors’ separate report on compliance with laws and regulations that was drafted by a staff accountant of Hall & Hall at the completion of the engagement contained the statements below. It was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that no material instances of noncompliance were identified.

1. A statement that the audit was conducted in accordance with generally accepted auditing standards and with Government Auditing Standards issued by the Controller General of the United States.

2. A statement that the auditors’ procedures included tests of compliance.

3. A statement that the standards require the auditors to plan and to perform the audit to detect all instances of noncompliance with applicable laws and regulations.

4. A statement that management is responsible for compliance with laws, regulations, contracts, and grants.

5. A statement that the auditors’ objective was to provide an opinion on compliance with the provisions of laws and regulations equivalent to that to be expressed on the financial statements.

6. A statement of positive assurance that the results of the tests indicate that, with respect to the items tested, the entity complied, in all material respects, with the provisions of laws, regulations, contracts, and grants.

7. A statement of negative assurance that, with respect to items tested, nothing came to the auditors’ attention that caused the auditors to believe that the entity had not complied, in all material respects, with the provisions of laws, regulations, contracts, and grants.

8. A statement that the report is intended only for the information of the specific legislative or regulatory bodies, and that this restriction is intended to limit the distribution of the report.

Required:
For each of the above statements indicate whether each is an appropriate or inappropriate element within the report on compliance with laws and regulations. If a statement is not appropriate, explain why.

Number 3 (Estimated time — 15 to 25 minutes)

Smith, CPA, has been engaged to audit the financial statements of Reed, Inc., a publicly held retailing company. Before assessing control risk Smith is required to obtain an understanding of Reed’s control environment.

Required:

a. Identify additional control environment factors (excluding the factor illustrated in the example below) that establish, enhance, or mitigate the effectiveness of specific policies and procedures.

b. For the control environment factors identified in a, describe the components that could be of interest to the auditor.

Use the following format:

Management Philosophy and Operating Style

Management philosophy and operating style characteristics may include the following: management’s approach to taking and monitoring business risks; management’s attitudes and actions toward financial reporting; and management’s emphasis on meeting budget, profit, and other financial and operating goals.
Auditing

Number 4 (Estimated time — 15 to 25 minutes)

Larkin, CPA, has been engaged to audit the financial statements of Vernon Distributors, Inc., a continuing audit client, for the year ended September 30, 1991. After obtaining an understanding of Vernon’s internal control structure, Larkin assessed control risk at the maximum level for all financial statement assertions concerning investments. Larkin determined that Vernon is unable to exercise significant influence over any investee and none are related parties.

Larkin obtained from Vernon detailed analyses of its investments in domestic securities showing:

• The classification between current and noncurrent portfolios;
• A description of each security, including the interest rate and maturity date of bonds and par value and dividend rate on stocks;
• A notation of the location of each security, either in the Treasurer’s safe or held by an independent custodian;
• The number of shares of stock or face amount of bonds held at the beginning and end of the year;
• The beginning and ending balances at cost and at market, and the unamortized premium or discount on bonds;
• Additions to and sales from the portfolios for the year, including date, number of shares, face amount of bonds, cost, proceeds, and realized gain or loss;
• Valuation allowances at the beginning and end of the year and changes therein;
• Accrued investment income for each investment at the beginning and end of the year, and income earned and collected during the year.

Larkin then prepared the following partial audit program of substantive auditing procedures:

1. Foot and crossfoot the analyses.
2. Trace the ending totals to the general ledger and financial statements.
3. Trace the beginning balances to the prior year’s working papers.
4. Obtain positive confirmation as of the balance sheet date of the investments held by any independent custodian.
5. Determine that income from investments has been properly recorded as accrued or collected by reference to published sources, by computation, and by tracing to recorded amounts.

6. For investments in nonpublic entities, compare carrying value to information in the most recently available audited financial statements.
7. Determine that all transfers between the current and noncurrent portfolios have been properly authorized and recorded.
8. Determine that any other-than-temporary decline in the price of an investment has been properly recorded.

Required:

a. Identify the primary financial statement assertion relative to investments that would be addressed by each of the procedures #4 through #8 and describe the primary audit objective of performing that procedure. Use the format illustrated below.

<table>
<thead>
<tr>
<th>Primary Assertion</th>
<th>Objective</th>
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b. Describe three additional substantive auditing procedures Larkin should consider in auditing Vernon’s investments.
Number 5 (Estimated time — 15 to 25 minutes)

Baker, CPA, was engaged to audit Mill Company’s financial statements for the year ended September 30, 1991. After obtaining an understanding of Mill’s internal control structure, Baker decided to obtain evidential matter about the effectiveness of both the design and operation of the policies and procedures that may support a low assessed level of control risk concerning Mill’s shipping and billing functions. During the prior years’ audits Baker used nonstatistical sampling, but for the current year Baker used a statistical sample in the tests of controls to eliminate the need for judgment.

Baker wanted to assess control risk at a low level, so a tolerable rate of deviation or acceptable upper precision limit (UPL) of 20% was established. To estimate the population deviation rate and the achieved UPL, Baker decided to apply a discovery sampling technique of attribute sampling that would use a population expected error rate of 3% for the 8,000 shipping documents, and decided to defer consideration of allowable risk of assessing control risk too low (risk of overreliance) until evaluating the sample results. Baker used the tolerable rate, the population size, and the expected population error rate to determine that a sample size of 80 would be sufficient. When it was subsequently determined that the actual population was about 10,000 shipping documents, Baker increased the sample size to 100.

Baker’s objective was to ascertain whether Mill’s shipments had been properly billed. Baker took a sample of 100 invoices by selecting the first 25 invoices from the first month of each quarter. Baker then compared the invoices to the corresponding prenumbered shipping documents.

When Baker tested the sample, eight errors were discovered. Additionally, one shipment that should have been billed at $10,443 was actually billed at $10,434. Baker considered this $9 to be immaterial and did not count it as an error.

In evaluating the sample results Baker made the initial determination that a reliability level of 95% (risk of assessing control risk too low 5%) was desired and, using the appropriate statistical sampling table, determined that for eight observed deviations from a sample size of 100, the achieved UPL was 14%. Baker then calculated the allowance for sampling risk to be 5%, the difference between the actual sample deviation rate (8%) and the expected error rate (3%). Baker reasoned that the actual sample deviation rate (8%) plus the allowance for sampling risk (5%) was less than the achieved UPL (14%); therefore, the sample supported a low level of control risk.

Required:

Describe each incorrect assumption, statement, and inappropriate application of attribute sampling in Baker’s procedures.
EXAMINATION IN BUSINESS LAW  
(Commercial Law)  
November 8, 1991; 8:30 A.M. to 12:00 Noon

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

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INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

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 multiple-choice answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all multiple-choice items on the printed multiple-choice answer sheet. You should attempt to answer all multiple-choice items. There is no penalty for incorrect responses. Since the multiple-choice items are computer-graded, your comments and calculations associated with them are not considered and should not be submitted. Be certain that you have entered your answers on the multiple-choice answer sheet before the examination time is up. The multiple-choice portion of your examination will not be graded if you fail to record your answers on the multiple-choice answer sheet.

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 candidates’ 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.

4. Write your 7-digit candidate number in the space provided at the upper right-hand corner of this page.

5. You must hand in your examination answer booklet, multiple-choice answer sheet, and green essay answer worksheets. Your examination will not be graded unless your examination question booklet, multiple-choice answer sheet, and green essay answer worksheets are handed in before leaving the examination room.

6. If you want your examination question booklet mailed to you, write your name and address on the back cover, and place 52 cents postage in the space provided, unless otherwise instructed. Also, unless instructed otherwise, write your name and address in the return address space in the upper left-hand corner on the back cover. Examination question booklets will be distributed no sooner than the day following the administration of this examination, unless instructed otherwise.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.
Number 1 (Estimated time — 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 correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

98. Bridge Builders, Inc. sent the following letter to Allied Steel Co.:

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

98. a b . d

Items to be Answered

1. Cable Corp. orally engaged Drake & Co., CPAs, to audit its financial statements. Cable's management informed Drake that it suspected the accounts receivable were materially overstated. Though the financial statements Drake audited included a materially overstated accounts receivable balance, Drake issued an unqualified opinion. Cable used the financial statements to obtain a loan to expand its operations. Cable defaulted on the loan and incurred a substantial loss.

If Cable sues Drake for negligence in failing to discover the overstatement, Drake's best defense would be that Drake did not

a. Have privity of contract with Cable.
b. Sign an engagement letter.
c. Perform the audit recklessly or with an intent to deceive.
d. Violate generally accepted auditing standards in performing the audit.

2. When performing an audit, a CPA

a. Must exercise the level of care, skill, and judgment expected of a reasonably prudent CPA under the circumstances.
b. Must strictly adhere to generally accepted accounting principles.
c. Is strictly liable for failing to discover client fraud.
d. Is not liable unless the CPA commits gross negligence or intentionally disregards generally accepted auditing standards.

3. Ford & Co., CPAs, issued an unqualified opinion on Owens Corp.'s financial statements. Relying on these financial statements, Century Bank lent Owens $750,000. Ford was unaware that Century would receive a copy of the financial statements or that Owens would use them to obtain a loan. Owens defaulted on the loan.

To succeed in a common law fraud action against Ford, Century must prove, in addition to other elements, that Century was

a. Free from contributory negligence.
b. In privity of contract with Ford.
c. Justified in relying on the financial statements.
d. In privity of contract with Owens.

4. Hark, CPA, failed to follow generally accepted auditing standards in auditing Long Corp.'s financial statements. Long's management had told Hark that the audited statements would be submitted to several banks to obtain financing. Relying on the statements, Third Bank gave Long a loan. Long defaulted on the loan. In a jurisdiction applying the Ultramares decision, if Third sues Hark, Hark will

a. Win because there was no privity of contract between Hark and Third.
b. Lose because Hark knew that banks would be relying on the financial statements.
c. Win because Third was contributorily negligent in granting the loan.
d. Lose because Hark was negligent in performing the audit.

5. A CPA who fraudulently performs an audit of a corporation's financial statements will

a. Probably be liable to any person who suffered a loss as a result of the fraud.
b. Be liable only to the corporation and to third parties who are members of a class of intended users of the financial statements.
c. Probably be liable to the corporation even though its management was aware of the fraud and did not rely on the financial statements.
d. Be liable only to third parties in privity of contract with the CPA.
6. Quincy bought Teal Corp. common stock in an offering registered under the Securities Act of 1933. Worth & Co., CPAs, gave an unqualified opinion on Teal’s financial statements that were included in the registration statement filed with the SEC. Quincy sued Worth under the provisions of the 1933 Act that deal with omission of facts required to be in the registration statement. Quincy must prove that
   a. There was fraudulent activity by Worth.
   b. There was a material misstatement in the financial statements.
   c. Quincy relied on Worth’s opinion.
   d. Quincy was in privity with Worth.

7. For a CPA to be liable for damages under the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, a plaintiff must prove all of the following except that
   a. The plaintiff relied on the financial statements audited by the CPA.
   b. The CPA violated generally accepted auditing standards.
   c. There was a material misrepresentation of fact in the financial statements audited by the CPA.
   d. The CPA acted with scienter.

8. Jay, CPA, gave an unqualified opinion on Nast Power Co.’s financial statements. Larkin bought Nast bonds in a public offering subject to the Securities Act of 1933. The registration statement filed with the SEC included Nast’s financial statements. Larkin sued Jay for misstatements contained in the financial statements under the provisions of Section 11 of the Securities Act of 1933. To prevail, Larkin must prove

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<td>b. Yes</td>
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<td>c. No</td>
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<td>d. No</td>
<td>Yes</td>
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9. A CPA who prepares clients’ federal income tax returns for a fee must
   a. File certain required notices and powers of attorney with the IRS before preparing any returns.
   b. Keep a completed copy of each return for a specified period of time.
   c. Receive client documentation supporting all travel and entertainment expenses deducted on the return.
   d. Indicate the CPA’s federal identification number on a tax return only if the return reflects tax due from the taxpayer.

10. Which of the following statements is correct with respect to ownership, possession, or access to a CPA firm’s audit workpapers?
    a. Workpapers are subject to the privileged communication rule which, in most jurisdictions, prevents any third-party access to the workpapers.
    b. Workpapers may never be obtained by third parties unless the client consents.
    c. Workpapers are the client’s exclusive property.
    d. Workpapers are not transferable to a purchaser of a CPA practice unless the client consents.

11. Forming an agency relationship requires that
    a. The agreement between the principal and agent be supported by consideration.
    b. The principal and agent not be minors.
    c. Both the principal and agent consent to the agency.
    d. The agent’s authority be limited to the express grant of authority in the agency agreement.

12. When an agent acts for an undisclosed principal, the principal will not be liable to third parties if the
    a. Principal ratifies a contract entered into by the agent.
    b. Agent acts within an implied grant of authority.
    c. Agent acts outside the grant of actual authority.
    d. Principal seeks to conceal the agency relationship.

13. Orr gives North power of attorney. In general, the power of attorney
    a. Will be valid only if North is a licensed attorney at law.
    b. May continue in existence after Orr’s death.
    c. May limit North’s authority to specific transactions.
    d. Must be signed by both Orr and North.

14. A general partnership must
    a. Pay federal income tax.
    b. Have two or more partners.
    c. Have written articles of partnership.
    d. Provide for apportionment of liability for partnership debts.

15. In a general partnership, the authorization of all partners is required for an individual partner to bind the partnership in a business transaction to
    a. Purchase inventory.
    b. Hire employees.
    c. Sell goodwill.
    d. Sign advertising contracts.
16. In a general partnership, a partner’s interest in specific partnership property is
   a. Transferable to a partner’s individual creditors.
   b. Subject to a partner’s liability for alimony.
   c. Transferable to a partner’s estate upon death.
   d. Subject to a surviving partner’s right of survivorship.

17. On dissolution of a general partnership, distributions will be made on account of:
   I. Partners’ capital accounts
   II. Amounts owed partners with respect to profits
   III. Amounts owed partners for loans to the partnership
   in the following order
   a. III, I, II.
   b. I, II, III.
   c. II, III, I.
   d. III, II, I.

18. Which of the following is not necessary to create an express trust?
   a. A trust corpus.
   b. A successor trustee.
   c. A valid trust purpose.
   d. A beneficiary.

19. A trustee’s fiduciary duty will probably be violated if the trustee
   a. Invests trust property in government bonds.
   b. Performs accounting services for the trust.
   c. Sells unproductive trust property.
   d. Borrows money from the trust.

20. An irrevocable spendthrift trust established for a period of ten years will be terminated if the
   a. Income beneficiaries die.
   b. Trustee resigns.
   c. Income beneficiaries agree to the trust’s termination.
   d. Grantor decides to terminate the trust.

21. The intent, or scienter, element necessary to establish a cause of action for fraud will be met if the plaintiff can show that the
   a. Defendant made a misrepresentation with a reckless disregard for the truth.
   b. Defendant made a false representation of fact.
   c. Plaintiff actually relied on the defendant’s misrepresentation.
   d. Plaintiff justifiably relied on the defendant’s misrepresentation.

22. Under the UCC Sales Article, a plaintiff who proves fraud in the formation of a contract may
   a. Elect to rescind the contract and need not return the consideration received from the other party.
   b. Be entitled to rescind the contract and sue for damages resulting from the fraud.
   c. Be entitled to punitive damages provided physical injuries resulted from the fraud.
   d. Rescind the contract even if there was no reliance on the fraudulent statement.

23. Two individuals signed a contract that was intended to be their entire agreement. The parol evidence rule will prevent the admission of evidence offered to
   a. Explain the meaning of an ambiguity in the written contract.
   b. Establish that fraud had been committed in the formation of the contract.
   c. Prove the existence of a contemporaneous oral agreement modifying the contract.
   d. Prove the existence of a subsequent oral agreement modifying the contract.

24. Yost contracted with Egan for Yost to buy certain real property. If the contract is otherwise silent, Yost’s rights under the contract are
   a. Assignable only with Egan’s consent.
   b. Nonassignable because they are personal to Yost.
   c. Nonassignable as a matter of law.
   d. Generally assignable.

25. On May 25, 1991, Smith contracted with Jackson to repair Smith’s cabin cruiser. The work was to begin on May 31, 1991. On May 26, 1991, the boat, while docked at Smith’s pier, was destroyed by arson. Which of the following statements is correct with regard to the contract?
   a. Smith would not be liable to Jackson because of mutual mistake.
   b. Smith would be liable to Jackson for the profit Jackson would have made under the contract.
   c. Jackson would not be liable to Smith because performance by the parties would be impossible.
   d. Jackson would be liable to repair another boat owned by Smith.

26. Mane Bank lent Eller $120,000 and received securities valued at $30,000 as collateral. At Mane’s request, Salem and Rey agreed to act as uncompensated co-sureties on the loan. The agreement provided that Salem’s and Rey’s maximum liability would be $120,000 each.
   Mane released Rey without Salem’s consent. Eller later defaulted when the collateral held by Mane was worthless and the loan balance was $90,000. Salem’s maximum liability is
   a. $30,000
   b. $45,000
   c. $60,000
   d. $90,000
27. Wool, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which of the following statements is correct?
   a. It is unnecessary for the required annual report (Form 10K) to include audited financial statements.
   b. Any person who owns more than 5% of Wool's common stock must file a report with the SEC.
   c. Because Wool is a reporting company, it is not required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.
   d. Wool need not file its proxy statements with the SEC because it has only one class of stock outstanding.

28. Which of the following statements is correct concerning the voluntary filing of a petition in bankruptcy?
   a. If the debtor has 12 or more creditors, the unsecured claims must total at least $5,000.
   b. The debtor must be insolvent.
   c. If the debtor has less than 12 creditors, the unsecured claims must total at least $5,000.
   d. The petition may be filed jointly by spouses.

29. To file for bankruptcy under Chapter 7 of the Federal Bankruptcy Code, an individual must
   a. Have debts of any amount.
   b. Be insolvent.
   c. Be indebted to more than three creditors.
   d. Have debts in excess of $5,000.

30. Which of the following claims would have the highest priority in the distribution of a bankruptcy estate under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code if the petition was filed June 1, 1991?

31. By signing a reaffirmation agreement on April 15, 1991, a debtor agreed to pay certain debts that would be discharged in bankruptcy. On June 20, 1991, the debtor's attorney filed the reaffirmation agreement and an affidavit with the court indicating that the debtor understood the consequences of the reaffirmation agreement. The debtor obtained a discharge on August 25, 1991. The reaffirmation agreement would be enforceable only if it was
   a. Made after discharge.
   b. Approved by the bankruptcy court.
   c. Not for a household purpose debt.
   d. Not rescinded before discharge.

32. Which of the following types of income is subject to taxation under the provisions of the Federal Insurance Contributions Act (FICA)?
   a. Interest earned on municipal bonds.
   b. Capital gains of $3,000.
   c. Car received as a productivity award.
   d. Dividends of $2,500.

33. An unemployed CPA generally would receive unemployment compensation benefits if the CPA
   a. Was fired as a result of the employer's business reversals.
   b. Refused to accept a job as an accountant while receiving extended benefits.
   c. Was fired for embezzling from a client.
   d. Left work voluntarily without good cause.

34. Workers' Compensation laws provide for all of the following benefits except
   a. Burial expenses.
   b. Full pay during disability.
   c. The cost of prosthetic devices.
   d. Monthly payments to surviving dependent children.

35. Exemption from registration under the Securities Act of 1933 would be available for
   a. Promissory notes maturing in 12 months.
   b. Securities of a bank.
   c. Limited partnership interests.
   d. Corporate bonds.

36. When a common stock offering requires registration under the Securities Act of 1933,
   a. The registration statement is automatically effective when filed with the SEC.
   b. The issuer would act unlawfully if it were to sell the common stock without providing the investor with a prospectus.
   c. The SEC will determine the investment value of the common stock before approving the offering.
   d. The issuer may make sales 10 days after filing the registration statement.

37. Under the Securities Act of 1933, an initial offering of securities must be registered with the SEC, unless
   a. The offering is made through a broker-dealer licensed in the states in which the securities are to be sold.
   b. The offering prospectus makes a fair and full disclosure of all risks associated with purchasing the securities.
   c. The issuer's financial condition meets certain standards established by the SEC.
   d. The type of security or the offering involved is exempt from registration.
38. Brown was unable to repay a loan from Safe Bank when due. Safe refused to renew the loan unless Brown provided an acceptable surety. Brown asked King, a friend, to act as surety on the loan. To induce King to agree to become a surety, Brown fraudulently represented Brown's financial condition and promised King discounts on merchandise sold at Brown's store. King agreed to act as surety and the loan was renewed. Later, Brown's obligation to Safe was discharged in Brown's bankruptcy. Safe wants to hold King liable. King may avoid liability
   a. Because the discharge in bankruptcy will prevent
      King from having a right of reimbursement.
   b. Because the arrangement was void at the inception.
   c. If King was an uncompensated surety.
   d. If King can show that Safe was aware of the fraudulent representations.

39. The reporting and registration provisions of the Securities Exchange Act of 1934
   a. Do not require registration by a corporation if
      its stock was originally issued under an offering
      exempt from registration under the Securities Act
      of 1933.
   b. Do not require registration by a corporation
      unless its stock is listed on a national securities
      exchange.
   c. Require a corporation reporting under the Act to
      register any offering of its securities under the
      Securities Act of 1933.
   d. Require a corporation reporting under the Act to
      file its proxy statements with the SEC even if it
      has only one class of stock outstanding.

40. Kamp is offering $10 million of its securities. Under
    Rule 506 of Regulation D of the Securities Act of 1933,
    a. The securities may be debentures.
    b. Kamp must be a corporation.
    c. There must be more than 35 purchasers.
    d. Kamp may make a general solicitation in connection
       with the offering.

41. Taso Limited Partnership intends to offer $400,000
    of its limited partnership interests under Rule 504 of Regulation D of the Securities Act of 1933. Which of the follow-
    ing statements is correct?
    a. The exemption under Rule 504 is not available
to an issuer of limited partnership interests.
    b. The limited partnership interests may be sold only
to accredited investors.
    c. The total number of nonaccredited investors who
purchase the limited partnership interests may not
exceed 35.
    d. The resale of the limited partnership interests by
a purchaser generally will be restricted.

42. If a creditor challenged Master's right to file, the peti-
tion would be dismissed
   a. If Master had less than 12 creditors at the time
      of filing.
   b. Unless Master can show that a reorganization
      under Chapter 11 of the Federal Bankruptcy
      Code would have been unsuccessful.
   c. Unless Master can show that it is unable to pay
      its debts in the ordinary course of business or as
      they come due.
   d. If Master is an insurance company.

43. If Master's voluntary petition is filed properly,
   a. Master will be entitled to conduct its business as
      a debtor-in-possession unless the court appoints
      a trustee.
   b. A trustee must be appointed by the creditors.
   c. Lawsuits by Master's creditors will be stayed by
      the Federal Bankruptcy Code.
   d. The unsecured creditors must elect a creditors'
      committee of three to eleven members to consult
      with the trustee.

44. Master's payment to Acme could
   a. Be set aside as a preferential transfer because the
      fair market value of the collateral was greater than
      the installment note balance.
   b. Be set aside as a preferential transfer unless Acme
      showed that Master was solvent on January 15,
   c. Not be set aside as a preferential transfer because
      Acme was oversecured.
   d. Not be set aside as a preferential transfer if Acme
      showed that Master was solvent on March 15,
45. Which of the following statements correctly describes Acme's distribution from Master's bankruptcy estate?
   a. Acme will receive the total amount it is owed, even if the proceeds from the sale of the collateral were less than the balance owed by Master.
   b. Acme will have the same priority as unsecured general creditors to the extent that the proceeds from the sale of its collateral are insufficient to satisfy the amount owed by Master.
   c. The total proceeds from the sale of the collateral will be paid to Acme even if they are less than the balance owed by Master, provided there is sufficient cash to pay all administrative costs associated with the bankruptcy.
   d. Acme will receive only the proceeds from the sale of the collateral in full satisfaction of the debt owed by Master.

---

**Items 46 and 47 relate to the following instrument:**

\[ \text{May 19, 1991} \]

I promise to pay to the order of A.B. Shark $1,000 (One thousand and one hundred dollars) with interest thereon at the rate of 12% per annum.

\[ \text{T. T. Tile} \]

\[ \text{T. T. Tile} \]

**Guaranty**

I personally guaranty payment by T. T. Tile.

\[ \text{N. A. Abner} \]

\[ \text{N. A. Abner} \]

46. The instrument is a
   a. Promissory demand note.
   b. Sight draft.
   c. Check.
   d. Trade acceptance.

47. The instrument is
   a. Nonnegotiable even though it is payable on demand.
   b. Nonnegotiable because the numeric amount differs from the written amount.
   c. Negotiable even though a payment date is not specified.
   d. Negotiable because of Abner's guaranty.

---

48. For a person to be a holder in due course of a promissory note
   a. The note must be payable in U.S. currency to the holder.
   b. The holder must be the payee of the note.
   c. The note must be negotiable.
   d. All prior holders must have been holders in due course.

49. Cobb gave Garson a signed check with the amount payable left blank. Garson was to fill in, as the amount, the price of fuel oil Garson was to deliver to Cobb at a later date. Garson estimated the amount at $700, but told Cobb it would be no more than $900. Garson did not deliver the fuel oil, but filled in the amount of $1,000 on the check. Garson then negotiated the check to Josephs in satisfaction of a $500 debt with the $500 balance paid to Garson in cash. Cobb stopped payment and Josephs is seeking to collect $1,000 from Cobb. Cobb's maximum liability to Josephs will be
   a. $0
   b. $500
   c. $900
   d. $1,000

50. A subsequent holder of a negotiable instrument may cause the discharge of a prior holder of the instrument by any of the following actions except
   a. Unexcused delay in presentment of a time draft.
   b. Procuring certification of a check.
   c. Giving notice of dishonor the day after dishonor.
   d. Material alteration of a note.

51. A tenant's personal property will become a fixture and belong to the landlord if its removal would
   a. Increase the value of the personal property.
   b. Cause a material change to the personal property.
   c. Result in substantial harm to the landlord's property.
   d. Change the use of the landlord's property back to its prior use.

52. Konrad, Van, and Star own a parcel of land as joint tenants with right of survivorship. Konrad's interest was sold to Dawson. As a result of the sale from Konrad to Dawson,
   a. Van and Star each own one-third of the land as tenants in common.
   b. Van, Star, and Dawson each own one-third of the land as joint tenants.
   c. Dawson owns one-third of the land as a joint tenant.
   d. Dawson owns one-third of the land as a tenant in common.

N-43
53. To be enforceable, a residential real estate lease must
   a. Require the tenant to obtain liability insurance.
   b. Entitle the tenant to exclusive possession of the
      leased property.
   c. Specify a due date for rent.
   d. Be in writing.

54. A purchaser who obtains real estate title insurance will
   a. Have coverage for the title exceptions listed in
      the policy.
   b. Be insured against all defects of record other than
      those excepted in the policy.
   c. Have coverage for title defects that result from
      events that happen after the effective date of the
      policy.
   d. Be entitled to transfer the policy to subsequent
      owners.

55. A mortgage on real property must
   a. Be acknowledged by the mortgagee.
   b. State the exact amount of the debt.
   c. State the consideration given for the mortgage.
   d. Be delivered to the mortgagee.

56. If a mortgagor fails to record its mortgage in a jurisdic-
    tion with a notice-race recording statute,
   a. A subsequent recording mortgagee who has no
      knowledge of the prior mortgage will have a
      superior security interest.
   b. A subsequent recording mortgagee who has
      knowledge of the prior mortgage will have a
      superior security interest.
   c. A subsequent purchaser for value who has no
      knowledge of the mortgagee will take the property
      subject to the mortgage.
   d. A subsequent purchaser for value who has
      knowledge of the mortgagee will take the property
      free of the prior security interest.

57. Which of the following is correct regarding
    foreclosure of a purchase money mortgage by judicial sale
    of the property?
   a. The mortgagor has the right to any remaining sale
      proceeds after the mortgage is paid.
   b. The purchaser at the sale is liable for any defi-
      ciency owed the mortgagee.
   c. The court must confirm any price received at the
      sale.
   d. The mortgagor can never be liable for a
      deficiency owed the mortgagee.

58. Wyn bought real estate from Duke and gave Duke a
    purchase money mortgage. Duke forgot to record the mort-
    gage. Two months later, Wyn gave a mortgage on the same
    property to Goode to secure a property improvement loan.
    Goode recorded this mortgage nine days later. Goode knew
    about the Duke mortgage. If these events took place in a
    notice-race statute jurisdiction, which mortgage would have
    priority?
   a. Duke's, because it was the first mortgage given.
   b. Duke's, because Goode knew of the Duke
      mortgage.
   c. Goode's, because it was the first mortgage
      recorded.
   d. Goode's, because it was recorded within ten
      days.

59. In 1985, Ring purchased a building for $90,000 and
    insured it with a $90,000 fire insurance policy having a stan-
    dard 80% coinsurance clause. Ring never increased the
    amount of the policy. In 1990, the building, worth
    $120,000, was destroyed by fire. What amount could Ring
    collect from the insurance company?
   a. $0
   b. $72,000
   c. $90,000
   d. $120,000

60. Mason Co. maintained two standard fire insurance
    policies on one of its warehouses. Both policies included
    an 80% coinsurance clause and a typical "other insurance"
    clause. One policy was with Ace Fire Insurance, Inc., for
    $24,000, and the other was with Thrifty Casualty Insurance
    Co., for $16,000. At a time when the warehouse was worth
    $100,000, a fire in the warehouse caused a $40,000 loss.
    What amounts can Mason recover from Ace and Thrifty,
    respectively?
   a. $0 and $0.
   b. $10,000 and $10,000.
   c. $12,000 and $8,000.
   d. $24,000 and $16,000.
Frost, Glen, and Bradley own 50%, 40%, and 10%, respectively, of the authorized and issued voting common stock of Xeon Corp. They had a written stockholders’ agreement that provided they would vote for each other as directors of the corporation.

At the initial stockholders’ meeting, Frost, Glen, Bradley, and three others were elected to a six-person board of directors. The board elected Frost as president of the corporation, Glen as secretary, and Bradley as vice president. Frost and Glen were given two-year contracts with annual salaries of $50,000. Bradley was given a two-year contract for $10,000 per year.

At the end of its first year of operation, Xeon was in financial difficulty. Bradley disagreed with the way Frost and Glen were running the business.

At the annual stockholders’ meeting, a new board of directors was elected. Bradley was excluded because Frost and Glen did not vote for Bradley. Without cause, the new board fired Bradley as vice president even though 12 months remained on Bradley’s contract.

Despite the corporation’s financial difficulties, the new board, relying on the assurances of Frost and Glen and based on fraudulent documentation provided by Frost and Glen, declared and paid a $200,000 dividend. Payment of the dividend caused the corporation to become insolvent.

- Bradley sued Frost and Glen to compel them to follow the written stockholders’ agreement and reinstate Bradley to the board.

- Bradley sued the corporation to be reinstated as an officer of the corporation, and for breach of the employment contract.

- Bradley sued each member of the board for declaring and paying an unlawful dividend, and demanded its repayment to the corporation.

**Required:**

State whether Bradley would be successful in each of the above suits and give the reasons for your conclusions.

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**Number 3 (Estimated time — 15 to 20 minutes)**

In a signed letter dated March 2, 1991, Stake offered to sell Packer a specific vacant parcel of land for $100,000. Stake had inherited the land, along with several apartment buildings in the immediate vicinity. Packer received the offer on March 4. The offer required acceptance by March 10 and required Packer to have the property surveyed by a licensed surveyor so the exact legal description of the property could be determined.

On March 6, Packer sent Stake a counteroffer of $75,000. All other terms and conditions of the offer were unchanged. Stake received Packer’s counteroffer on March 8, and, on that day, telephoned Packer and accepted it. On learning that a survey of the vacant parcel would cost about $1,000, Packer telephoned Stake on March 11 requesting that they share the survey cost equally. During this conversation, Stake agreed to Packer’s proposal.

During the course of the negotiations leading up to the March communications between Stake and Packer, Stake expressed concern to Packer that a buyer of the land might build apartment units that would compete with those owned by Stake in the immediate vicinity. Packer assured Stake that Packer intended to use the land for a small shopping center. Because of these assurances, Stake was willing to sell the land to Packer. Contrary to what Packer told Stake, Packer had already contracted conditionally with Rolf for Rolf to build a 48-unit apartment development on the vacant land to be purchased from Stake.

During the last week of March, Stake learned that the land to be sold to Packer had a fair market value of $200,000. Also, Stake learned that Packer intended to build apartments on the land. Because of this information, Stake sued Packer to rescind the real estate contract, alleging that:

- Packer committed fraud in the formation of the contract thereby entitling Stake to rescind the contract.

- Stake’s innocent mistake as to the fair market value of the land entitles Stake to rescind the contract.

- The contract was not enforceable against Stake because Stake did not sign Packer’s March 6 counteroffer.

**Required:**

State whether Stake’s allegations are correct and give the reasons for your conclusions.
Number 4 (Estimated time — 15 to 20 minutes)

On October 10, Vesta Electronics contracted with Zap Audio to sell Zap 200 18” stereo speakers. The contract provided that the speakers would be shipped F.O.B. seller’s loading dock. The contract was silent as to when risk of loss for the speakers would pass to Zap. Delivery was to be completed by November 10.

On October 18, Vesta identified the speakers to be shipped to Zap and moved them to the loading dock. Before the carrier picked up the goods, a fire on Vesta’s loading dock destroyed 50 of the speakers. On October 20, Vesta shipped, by common carrier, the remaining 150 18” speakers and 50 16” speakers. The truck carrying the speakers was involved in an accident resulting in damage to 25 of the 16” speakers. Zap received the 200 speakers on October 25, and on October 27 notified Vesta that 100 of the 18” speakers were being accepted but the rest of the shipment was being rejected. Zap also informed Vesta that, due to Vesta’s failure to comply with the terms of the contract, Zap would contest paying the contract price and would sue for damages.

The above parties and transactions are subject to the Uniform Commercial Code (UCC).

Required:

Answer the following questions, and give the reasons for your conclusions.

a. 1. Who bears the risk of loss for the 50 destroyed 18” speakers?
   2. Who bears the risk of loss for the 25 damaged 16” speakers?

b. 1. Was Zap’s rejection of the 16” speakers valid?
   2. Was Zap’s acceptance of some of the 18” speakers valid?

c. Under the UCC, what duties are required of Zap after rejecting all or part of the shipment?

Number 5 (Estimated time — 15 to 20 minutes)

Mead, a junior member of a CPA firm’s audit staff, was assigned to assist in auditing Abco Electronics, Inc.’s financial statements. Abco sells various brands of computer equipment to the general public, and to distributors who sell the equipment to retail customers for personal and business use. One of Mead’s assignments was to evaluate the following transactions:

- On September 1, Abco sold a CDM computer out of its inventory to Rice, who intended to use it for business purposes. Rice paid 25% of the purchase price and executed and delivered to Abco a promissory note for the balance. A security agreement was signed only by the Abco sales representative. Abco failed to file a financing statement. Rice is in default under the promissory note. Rice claimed that Abco does not have an effective security interest in the computer because Rice did not sign the security agreement, and because Abco did not file a financing statement.

- On August 18, Abco sold a computer to Baker, who intended to use it for business inventory and accounts payable control, and payroll processing. Baker paid 20% of the purchase price and executed and delivered to Abco a promissory note for the balance and a security agreement covering the computer. Abco filed a financing statement on August 27. On August 25, Baker borrowed $5,000 from Condor Finance Co., giving Condor a promissory note for the loan amount and a security agreement covering the computer. Condor filed a financing statement on August 26. Baker defaulted on the promissory note given to Abco and its obligation to Condor. Condor has asserted that its security interest in the computer is superior to Abco’s.

Required:

State whether the claims of Rice and Condor are correct and give the reasons for your conclusions.
EXAMINATION IN ACCOUNTING THEORY
November 8, 1991; 1:30 P.M. to 5:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

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<thead>
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INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

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 multiple-choice answer sheet is page 1 and your other pages should be numbered 2 through 12.

2. Answer all multiple-choice items on the printed multiple-choice answer sheet. You should attempt to answer all multiple-choice items. There is no penalty for incorrect responses. Since the multiple-choice items are computer-graded, your comments and calculations associated with them are not considered and should not be submitted. Be certain that you have entered your answers on the multiple-choice answer sheet before the examination time is up. The multiple-choice portion of your examination will not be graded if you fail to record your answers on the multiple-choice answer sheet.

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 candidates' 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.

4. Write your 7-digit candidate number in the space provided at the upper right-hand corner of this page.

5. You must hand in your examination question booklet, multiple-choice answer sheet, and green essay answer worksheets. Your examination will not be graded unless your examination question booklet, multiple-choice answer sheet, and green essay answer worksheets are handed in before leaving the examination room.

6. If you want your examination question booklet mailed to you, write your name and address on the back cover, and place 52 cents postage in the space provided, unless otherwise instructed. Also, unless instructed otherwise, write your name and address in the return address space in the upper left-hand corner on the back cover. Examination question booklets will be distributed no sooner than the day following the administration of this examination, unless instructed otherwise.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.
Number 1 (Estimated time —— 90 to 110 minutes)

Instructions

Select the best answer for each of the following items relating to a variety of issues in accounting. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. Mark only one answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

**Item**

98. The financial statement that summarizes a company’s financial position is the
   a. Income statement.
   b. Balance sheet.
   c. Statement of cash flows.
   d. Retained earnings statement.

**Answer Sheet**

98. [ ] [ ] [ ] [ ]

1. FASB’s conceptual framework explains both financial and physical capital maintenance concepts. Which capital maintenance concept is applied to currently reported net income, and which is applied to comprehensive income?

<table>
<thead>
<tr>
<th>Currently reported net income</th>
<th>Comprehensive income</th>
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<td>a. Financial capital</td>
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<td>c. Financial capital</td>
<td>Financial capital</td>
</tr>
<tr>
<td>d. Physical capital</td>
<td>Financial capital</td>
</tr>
</tbody>
</table>

2. For interim financial reporting, a company’s income tax provision for the second quarter of 1991 should be determined using the
   b. Effective tax rate expected to be applicable for the second quarter of 1991.
   c. Effective tax rate expected to be applicable for the full year of 1991 as estimated at the end of the first quarter of 1991.
   d. Effective tax rate expected to be applicable for the full year of 1991 as estimated at the end of the second quarter of 1991.

3. According to FASB Statement No. 96, Accounting for Income Taxes, justification for the method of determining periodic deferred tax expense is based on the concept of
   a. Matching of periodic expense to periodic revenue.
   b. Objectivity in the calculation of periodic expense.
   c. Recognition of assets and liabilities.
   d. Consistency of tax expense measurements with actual tax planning strategies.

4. At the end of year 1, Cody Co. reported a profit on a partially completed construction contract by applying the percentage-of-completion method. By the end of year 2, the total estimated profit on the contract at completion in year 3 had been drastically reduced from the amount estimated at the end of year 1. Consequently, in year 2, a loss equal to one-half of the year 1 profit was recognized. Cody used the completed-contract method for income tax purposes and had no other contracts. According to FASB Statement No. 96, Accounting for Income Taxes, the year 2 balance sheet should include a deferred tax

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</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>

5. During 1990, Tidal Co. began construction on a project scheduled for completion in 1992. At December 31, 1990, an overall loss was anticipated at contract completion. What would be the effect of the project on 1990 operating income under the percentage-of-completion method and the completed-contract method?

<table>
<thead>
<tr>
<th>Percentage-of-completion</th>
<th>Completed-contract</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>

6. For financial statement purposes, the installment method of accounting may be used if the
   a. Collection period extends over more than 12 months.
   b. Installments are due in different years.
   c. Ultimate amount collectible is indeterminate.
   d. Percentage-of-completion method is inappropriate.
Accounting Theory

7. Generally, which inventory costing method approximates most closely the current cost for each of the following?

<table>
<thead>
<tr>
<th></th>
<th>Cost of goods sold</th>
<th>Ending inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>LIFO</td>
<td>FIFO</td>
</tr>
<tr>
<td>b.</td>
<td>LIFO</td>
<td>LIFO</td>
</tr>
<tr>
<td>c.</td>
<td>FIFO</td>
<td>FIFO</td>
</tr>
<tr>
<td>d.</td>
<td>FIFO</td>
<td>LIFO</td>
</tr>
</tbody>
</table>

8. For which of the following reporting units is the preparation of combined financial statements most appropriate?
   a. A corporation and a majority-owned subsidiary with nonhomogeneous operations.
   b. A corporation and a foreign subsidiary with nonintegrated homogeneous operations.
   c. Several corporations with related operations with some common individual owners.
   d. Several corporations with related operations owned by one individual.

9. Pride, Inc. owns 80% of Simba, Inc.’s outstanding common stock. Simba, in turn, owns 10% of Pride’s outstanding common stock. What percentage of the common stock cash dividends declared by the individual companies should be reported as dividends declared in the consolidated financial statements?

<table>
<thead>
<tr>
<th>Dividends declared by Pride</th>
<th>Dividends declared by Simba</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. 90%</td>
<td>0%</td>
</tr>
<tr>
<td>b. 90%</td>
<td>20%</td>
</tr>
<tr>
<td>c. 100%</td>
<td>0%</td>
</tr>
<tr>
<td>d. 100%</td>
<td>20%</td>
</tr>
</tbody>
</table>

10. An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor’s share of investee’s undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor’s income statement for this year would be
   a. The portion of the dividends received this year that were in excess of the investor’s share of investee’s undistributed earnings since the date of investment.
   b. The portion of the dividends received this year that were not in excess of the investor’s share of investee’s undistributed earnings since the date of investment.
   c. The total amount of dividends received this year.
   d. Zero.

11. Cedar Co.’s planned combination with Birch Co. on January 1, 1992, can be structured as either a purchase or a pooling of interests. In a purchase, Cedar would acquire Birch’s identifiable net assets for less than their book values. These book values approximate fair values. Birch’s assets consist of current assets and depreciable noncurrent assets. How would the combined entity’s 1992 net income and operating cash flows under purchase accounting compare to those under pooling of interests accounting? Ignore costs required to effect the combination and income tax expense.

<table>
<thead>
<tr>
<th>Purchase accounting net income</th>
<th>Purchase accounting operating cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Equal to pooling</td>
<td>Greater than pooling</td>
</tr>
<tr>
<td>b. Equal to pooling</td>
<td>Equal to pooling</td>
</tr>
<tr>
<td>c. Greater than pooling</td>
<td>Greater than pooling</td>
</tr>
<tr>
<td>d. Greater than pooling</td>
<td>Equal to pooling</td>
</tr>
</tbody>
</table>

12. A business combination is accounted for as a pooling of interests. Costs of furnishing information to stockholders related to effecting the business combination should be
   a. Deducted directly from retained earnings of the combined corporation.
   b. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
   c. Capitalized but not amortized.
   d. Capitalized and subsequently amortized over a period not exceeding forty years.

13. Say Co. purchased Ivy Co. at a cost that resulted in recognition of goodwill having an expected 10-year benefit period. However, Say plans to make additional expenditures to maintain goodwill for a total of 40 years. What costs should be capitalized and over how many years should they be amortized?

<table>
<thead>
<tr>
<th>Costs capitalized</th>
<th>Amortization period</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Acquisition costs only</td>
<td>10 years</td>
</tr>
<tr>
<td>b. Acquisition costs only</td>
<td>40 years</td>
</tr>
<tr>
<td>c. Acquisition and maintenance costs</td>
<td>10 years</td>
</tr>
<tr>
<td>d. Acquisition and maintenance costs</td>
<td>40 years</td>
</tr>
</tbody>
</table>

14. When the equity method is used to account for investments in common stock, which of the following affects the investor’s reported investment income?

<table>
<thead>
<tr>
<th>Goodwill amortization related to purchase</th>
<th>Cash dividends from investee</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>
15. The Flat and Iron partnership agreement provides for Flat to receive a 20% bonus on profits before the bonus. Remaining profits and losses are divided between Flat and Iron in the ratio of 2 to 3, respectively. Which partner has a greater advantage when the partnership has a profit or when it has a loss?

<table>
<thead>
<tr>
<th>Profit</th>
<th>Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Flat</td>
<td>Iron</td>
</tr>
<tr>
<td>b. Flat</td>
<td>Flat</td>
</tr>
<tr>
<td>c. Iron</td>
<td>Flat</td>
</tr>
<tr>
<td>d. Iron</td>
<td>Iron</td>
</tr>
</tbody>
</table>

16. Earnings per share data should be reported on the income statement for

<table>
<thead>
<tr>
<th>Cumulative effect of a change in accounting principle</th>
<th>Income before extraordinary items</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>

17. Successful use of leverage is evidenced by a

a. Rate of return on investment greater than the rate of return on stockholders' equity.

b. Rate of return on investment greater than the cost of debt.

c. Rate of return on sales greater than the rate of return on stockholders' equity.

d. Rate of return on sales greater than the cost of debt.

18. Shore Co. records its transactions in U.S. dollars. A sale of goods resulted in a receivable denominated in Japanese yen, and a purchase of goods resulted in a payable denominated in French francs. Shore recorded a foreign exchange gain on collection of the receivable and an exchange loss on settlement of the payable. The exchange rates are expressed as so many units of foreign currency to one dollar. Did the number of foreign currency units exchangeable for a dollar increase or decrease between the contract and settlement dates?

<table>
<thead>
<tr>
<th>Yen exchangeable for $1</th>
<th>Francs exchangeable for $1</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

19. How would the proceeds received from the advance sale of nonrefundable tickets for a theatrical performance be reported in the seller's financial statements before the performance?

a. Revenue for the entire proceeds.

b. Revenue to the extent of related costs expended.

c. Unearned revenue to the extent of related costs expended.

d. Unearned revenue for the entire proceeds.

20. Dee's inventory and accounts payable balances at December 31, 1990, increased over their December 31, 1989, balances. Should these increases be added to or deducted from cash payments to suppliers to arrive at 1990 cost of goods sold?

<table>
<thead>
<tr>
<th>Increase in inventory</th>
<th>Increase in accounts payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Added to</td>
<td>Deducted from</td>
</tr>
<tr>
<td>b. Added to</td>
<td>Added to</td>
</tr>
<tr>
<td>c. Deducted from</td>
<td>Deducted from</td>
</tr>
<tr>
<td>d. Deducted from</td>
<td>Added to</td>
</tr>
</tbody>
</table>

21. Would the following be added back to net income when reporting operating activities' cash flows by the indirect method?

<table>
<thead>
<tr>
<th>Excess of treasury stock acquisition cost over sales proceeds (cost method)</th>
<th>Bond discount amortization</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. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

22. Bay Manufacturing Co. purchased a three-month U.S. Treasury bill. In preparing Bay's statement of cash flows, this purchase would

a. Have no effect.

b. Be treated as an outflow from financing activities.

c. Be treated as an outflow from investing activities.

d. Be treated as an outflow from lending activities.

23. In 1990, Teller Co. incurred losses arising from its guilty plea in its first antitrust action, and from a substantial increase in production costs caused when a major supplier's workers went on strike. Which of these losses should be reported as an extraordinary item?

<table>
<thead>
<tr>
<th>Antitrust action</th>
<th>Production costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Accounting Theory

24. The effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate should be reported
   a. By restating the financial statements of all prior periods presented.
   b. As a correction of an error.
   c. As a component of income from continuing operations, in the period of change and future periods if the change affects both.
   d. As a separate disclosure after income from continuing operations, in the period of change and future periods if the change affects both.

25. In single period statements, which of the following should be reflected as an adjustment to the opening balance of retained earnings?
   a. Effect of a failure to provide for uncollectible accounts in the previous period.
   b. Effect of a decrease in the estimated useful life of depreciable equipment.
   c. Cumulative effect of a change of income recognition from the installment sale method to recognition at point of sale.
   d. Cumulative effect of a change from an accelerated method to straight-line depreciation.

26. In 1990, Brighton Co. changed from the individual item approach to the aggregate approach in applying the lower of FIFO cost or market to inventories. The cumulative effect of this change should be reported in Brighton’s financial statements as a
   a. Prior period adjustment, with separate disclosure.
   b. Component of income from continuing operations, with separate disclosure.
   c. Component of income from continuing operations, without separate disclosure.
   d. Component of income after continuing operations, with separate disclosure.

27. Thread Co. is selecting its inventory system in preparation for its first year of operations. Thread intends to use either the periodic weighted average method or the perpetual moving average method, and to apply the lower of cost or market rule either to individual items or to the total inventory. Inventory prices are expected to generally increase throughout 1991, although a few individual prices will decrease. What inventory system should Thread select if it wants to maximize the inventory carrying amount at December 31, 1991?

<table>
<thead>
<tr>
<th>Inventory method</th>
<th>Cost or market application</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Perpetual</td>
<td>Total inventory</td>
</tr>
<tr>
<td>b. Perpetual</td>
<td>Individual item</td>
</tr>
<tr>
<td>c. Periodic</td>
<td>Total inventory</td>
</tr>
<tr>
<td>d. Periodic</td>
<td>Individual item</td>
</tr>
</tbody>
</table>

28. When the double extension approach to the dollar value LIFO inventory method is used, the inventory layer added in the current year is multiplied by an index number. Which of the following correctly states how components are used in the calculation of this index number?
   a. In the numerator, the average of the ending inventory at base year cost and at current year cost.
   b. In the numerator, the ending inventory at current year cost, and, in the denominator, the ending inventory at base year cost.
   c. In the numerator, the ending inventory at base year cost, and, in the denominator, the ending inventory at current year cost.
   d. In the denominator, the average of the ending inventory at base year cost and at current year cost.

29. Compensatory stock options were granted to executives on May 1, 1988, with a measurement date of October 31, 1989, for services rendered during 1988, 1989, and 1990. The excess of the market value of the stock over the option price at the measurement date was reasonably estimable at the date of grant. The stock options were exercised on June 30, 1991. Compensation expense should be recognized in which of the following years?

<table>
<thead>
<tr>
<th>Year</th>
<th>1988</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>b.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>c.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>d.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

30. Which of the following defined benefit pension plan disclosures should be made in a company’s financial statements?
   I. A description of the company’s funding policies and types of assets held.
   II. The amount of net periodic pension cost for the period.
   III. The fair value of plan assets.
   a. I and II.
   b. I, II, and III.
   c. II and III.
   d. I only.

31. An employer sponsoring a defined benefit pension plan is subject to the minimum pension liability recognition requirement. An additional liability must be recorded equal to the unfunded
   a. Accumulated benefit obligation plus the previously recognized accrued pension cost.
   b. Accumulated benefit obligation less the previously recognized accrued pension cost.
   c. Projected benefit obligation plus the previously recognized accrued pension cost.
   d. Projected benefit obligation less the previously recognized accrued pension cost.
32. On January 1, 1990, Jambon purchased equipment for use in developing a new product. Jambon uses the straight-line depreciation method. The equipment could provide benefits over a 10-year period. However, the new product development is expected to take five years, and the equipment can be used only for this project. Jambon’s 1990 expense equals
   a. The total cost of the equipment.
   b. One-fifth of the cost of the equipment.
   c. One-tenth of the cost of the equipment.
   d. Zero.

33. During January 1990, Vail Co. made long-term improvements to a recently leased building. The lease agreement provides for neither a transfer of title to Vail nor a bargain purchase option. The present value of the minimum lease payments equals 85% of the building’s market value, and the lease term equals 70% of the building’s economic life. Should assets be recognized for the building and the leasehold improvements?

<table>
<thead>
<tr>
<th>Building</th>
<th>Leasehold improvements</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. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

34. Jay’s lease payments are made at the end of each period. Jay’s liability for a capital lease would be reduced periodically by the
   a. Minimum lease payment less the portion of the minimum lease payment allocable to interest.
   b. Minimum lease payment plus the amortization of the related asset.
   c. Minimum lease payment less the amortization of the related asset.
   d. Minimum lease payment.

35. The market price of a bond issued at a discount is the present value of its principal amount at the market (effective) rate of interest
   a. Less the present value of all future interest payments at the market (effective) rate of interest.
   b. Less the present value of all future interest payments at the rate of interest stated on the bond.
   c. Plus the present value of all future interest payments at the market (effective) rate of interest.
   d. Plus the present value of all future interest payments at the rate of interest stated on the bond.

36. An issuer of bonds uses a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund and subsequently used to purchase investments. The sinking fund
   I. Increases by revenue earned on the investments.
   II. Is not affected by revenue earned on the investments.
   III. Decreases when the investments are purchased.

   a. I only.
   b. I and III.
   c. II and III.
   d. III only.

37. Bonds with detachable stock warrants were issued by Flack Co. Immediately after issue the aggregate market value of the bonds and the warrants exceeds the proceeds. Is the portion of the proceeds allocated to the warrants less than their market value, and is that amount recorded as contributed capital?

<table>
<thead>
<tr>
<th>Less than warrants’ market value</th>
<th>Contributed capital</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>

38. Tem Co. issued rights to its existing stockholders without consideration. A stockholder received a right to buy one share for each 20 shares held. The exercise price was in excess of par value, but less than the current market price. Retained earnings decreases when

<table>
<thead>
<tr>
<th>Rights are issued</th>
<th>Rights are exercised</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>Yes</td>
</tr>
</tbody>
</table>

39. Posy Corp. acquired treasury shares at an amount greater than their par value, but less than their original issue price. Compared to the cost method of accounting for treasury stock, does the par value method report a greater amount for additional paid-in capital and a greater amount for retained earnings?

<table>
<thead>
<tr>
<th>Additional paid-in capital</th>
<th>Retained earnings</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>
40. Grid Corp. acquired some of its own common shares at a price greater than both their par value and original issue price but less than their book value. Grid uses the cost method of accounting for treasury stock. What is the impact of this acquisition on total stockholders’ equity and the book value per common share?

<table>
<thead>
<tr>
<th>Total stockholders’ equity</th>
<th>Book value per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

41. In a job cost system, manufacturing overhead is

<table>
<thead>
<tr>
<th>An indirect cost of jobs</th>
<th>A necessary element in production</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>Yes</td>
</tr>
<tr>
<td>d. Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

42. A standard cost system may be used in

a. Neither process costing nor job order costing.
b. Process costing but not job order costing.
c. Either job order costing or process costing.
d. Job order costing but not process costing.

43. A direct labor overtime premium should be charged to a specific job when the overtime is caused by the

a. Increased overall level of activity.
b. Customer’s requirement for early completion of job.
c. Management’s failure to include the job in the production schedule.
d. Management’s requirement that the job be completed before the annual factory vacation closure.

44. During June, Delta Co. experienced scrap, normal spoilage, and abnormal spoilage in its manufacturing process. The cost of units produced includes

a. Scrap, but not spoilage.
b. Normal spoilage, but neither scrap nor abnormal spoilage.
c. Scrap and normal spoilage, but not abnormal spoilage.
d. Scrap, normal spoilage, and abnormal spoilage.

45. A single-product company prepares income statements using both absorption and variable costing methods. Manufacturing overhead cost applied per unit produced in 1990 was the same as in 1989. The 1990 variable costing statement reported a profit whereas the 1990 absorption costing statement reported a loss. The difference in reported income could be explained by units produced in 1990 being

a. Less than units sold in 1990.
b. Less than the activity level used for allocating overhead to the product.
c. In excess of the activity level used for allocating overhead to the product.
d. In excess of units sold in 1990.

46. When production levels are expected to decline within a relevant range, and a flexible budget is used, what effect would be anticipated with respect to each of the following?

<table>
<thead>
<tr>
<th>Variable costs per unit</th>
<th>Fixed costs per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No change</td>
<td>No change</td>
</tr>
<tr>
<td>b. Increase</td>
<td>No change</td>
</tr>
<tr>
<td>c. No change</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Increase</td>
<td>Increase</td>
</tr>
</tbody>
</table>

47. In the budgeted profit/volume chart below, EG represents a two-product company’s profit path. EH and HG represent the profit paths of products #1 and #2, respectively.

![Budgeted Profit/Volume Chart](chart.png)

Sales prices and cost behavior were as budgeted, actual total sales equaled budgeted sales, and there were no inventories. Actual profit was greater than budgeted profit. Which product had actual sales in excess of budget, and what margin does OE divided by OF represent?

<table>
<thead>
<tr>
<th>Product with excess sales</th>
<th>OE/OF</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. #1</td>
<td>Contribution margin</td>
</tr>
<tr>
<td>b. #1</td>
<td>Gross margin</td>
</tr>
<tr>
<td>c. #2</td>
<td>Contribution margin</td>
</tr>
<tr>
<td>d. #2</td>
<td>Gross margin</td>
</tr>
</tbody>
</table>

N-53
48. Probability (risk) analysis is
   a. An extension of sensitivity analysis.
   b. Incompatible with sensitivity analysis.
   c. Used only for situations involving five or fewer possible outcomes.
   d. Used only for situations in which the summation of probability weights is less than one.

49. How are the following used in the calculation of the internal rate of return of a proposed project? Ignore income tax considerations.

<table>
<thead>
<tr>
<th>Residual sales value of project</th>
<th>Depreciation expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Exclude</td>
<td>Include</td>
</tr>
<tr>
<td>b. Include</td>
<td>Include</td>
</tr>
<tr>
<td>c. Exclude</td>
<td>Exclude</td>
</tr>
<tr>
<td>d. Include</td>
<td>Exclude</td>
</tr>
</tbody>
</table>

50. Which combination of changes in asset turnover and income as a percentage of sales will maximize the return on investment?

<table>
<thead>
<tr>
<th>Asset turnover</th>
<th>Income as a percentage of sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Increase</td>
<td>Decrease</td>
</tr>
<tr>
<td>b. Increase</td>
<td>Increase</td>
</tr>
<tr>
<td>c. Decrease</td>
<td>Increase</td>
</tr>
<tr>
<td>d. Decrease</td>
<td>Decrease</td>
</tr>
</tbody>
</table>

51. One feature of state and local government accounting and financial reporting is that fixed assets used for general government activities
   a. Often are not expected to contribute to the generation of revenues.
   b. Do not depreciate as a result of such use.
   c. Are acquired only when direct contribution to revenues is expected.
   d. Should not be maintained at the same level as those of businesses so that current financial resources can be used for other government services.

52. If a city legally adopts its annual general fund budget on the modified accrual basis of accounting, its estimated revenues should be
   a. Reported on the modified accrual basis of accounting in the general fund statement of revenues, expenditures, and changes in fund balance—budget and actual.
   b. Converted to the cash basis of accounting and reported in the general fund statement of revenues, expenditures, and other changes in fund balance—budget and actual.
   c. Reported as current assets in the general fund balance sheet.
   d. Reported as noncurrent assets in the general fund balance sheet.

53. Gold County received goods that had been approved for purchase but for which payment had not yet been made. Should the accounts listed below be increased?

<table>
<thead>
<tr>
<th>Encumbrances</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. No</td>
<td>No</td>
</tr>
<tr>
<td>b. No</td>
<td>Yes</td>
</tr>
<tr>
<td>c. Yes</td>
<td>No</td>
</tr>
<tr>
<td>d. Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

54. In which of the following fund types of a city government are revenues and expenditures recognized on the same basis of accounting as the general fund?
   a. Nonexpendable trust.
   b. Internal service.
   c. Enterprise.
   d. Debt service.

55. An enterprise fund would be used when the governing body requires that
   I. Accounting for the financing of an agency's services to other government departments be on a cost-reimbursement basis.
   II. User charges cover the costs of general public services.
   III. Net income information be provided for an activity.
   a. I only.
   b. I and II.
   c. I and III.
   d. II and III.
56. On June 28, 1991, Silver City’s debt service fund received funds for the future repayment of bond principal. As a consequence, the long-term debt account group reported
   a. An increase in the amount available in debt service funds and an increase in the fund balance.
   b. An increase in the amount available in debt service funds and an increase in the amount to be provided for bonds.
   c. An increase in the amount available in debt service funds and a decrease in the amount to be provided for bonds.
   d. No changes in any amount until the bond principal is actually paid.

57. Funds received by a college from donors who have stipulated that the principal is nonexpendable but that the income generated may be expended by current operating funds would be accounted for in the
   a. Endowment fund.
   b. Term endowment fund.
   c. Agency fund.
   d. Quasi-endowment fund.

58. Clover City’s comprehensive annual financial report contains both combining and combined financial statements. Total columns are
   a. Required for both combining and combined financial statements.
   b. Optional, but commonly shown, for combining financial statements and required for combined financial statements.
   c. Required for combining financial statements and optional, but commonly shown, for combined financial statements.
   d. Optional, but commonly shown, for both combining and combined financial statements.

59. Dee City’s community hospital, which uses enterprise fund reporting, normally includes proceeds from sale of cafeteria meals in
   a. Patient service revenues.
   b. Other revenues.
   c. Ancillary service revenues.
   d. Deductions from dietary service expenses.

60. A nonprofit performing arts organization receives a donation that is restricted to its endowment and another donation that is restricted for use in acquiring a performing arts center. How should these donations be reported in the year received, assuming neither donation is expended in that year?

<table>
<thead>
<tr>
<th>Donation for endowment</th>
<th>Donation for performing arts center</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Deferred capital additions</td>
<td>Deferred capital additions</td>
</tr>
<tr>
<td>b. Deferred capital additions</td>
<td>Capital additions</td>
</tr>
<tr>
<td>c. Capital additions</td>
<td>Capital additions</td>
</tr>
<tr>
<td>d. Capital additions</td>
<td>Deferred capital additions</td>
</tr>
</tbody>
</table>
Number 2 (Estimated time — 15 to 25 minutes)

On September 30, 1989, Industrial Machinery Co. sold a machine and accepted the customer's noninterest-bearing note. Industrial normally makes sales on a cash basis. Since the machine was unique, its sales price was not determinable using Industrial's normal pricing practices.

After receiving the first of two equal annual installments on September 30, 1990, Industrial immediately discounted the note with recourse. On October 9, 1991, Industrial received notice that the note was dishonored, and it paid all amounts due. At all times prior to default, the note was reasonably expected to be paid in full.

Required:

a. 1. How should Industrial determine the sales price of the machine?
   2. How should Industrial report the effects of the noninterest-bearing note on its income statement for the year ended December 31, 1989? Why is this accounting presentation appropriate?

b. What are the effects of the discounting of the note receivable with recourse on Industrial's income statement for the year ended December 31, 1990, and its balance sheet at December 31, 1990?

c. How should Industrial account for the effects of the note being dishonored?

Number 3 (Estimated time — 15 to 25 minutes)

Portland Co. uses the straight-line depreciation method for depreciable assets. All assets are depreciated individually except manufacturing machinery, which is depreciated by the composite method.

During the year, Portland exchanged a delivery truck with Maine Co. for a larger delivery truck. It paid cash equal to 10% of the larger truck's value.

Required:

a. What factors should have influenced Portland's selection of the straight-line depreciation method?

b. How should Portland account for and report the truck exchange transaction?

c. 1. What benefits should Portland derive from using the composite method rather than the individual basis for manufacturing machinery?
   2. How should Portland have calculated the manufacturing machinery's annual depreciation expense in its first year of operation?
Supey Chemical Co. encountered the following two situations in 1990:

- Supey must pay an indeterminate amount for toxic waste cleanup on its land. An adjoining land owner, Gap Toothpaste, sold its property because of possible toxic contamination by Supey of the water supply and resulting potential adverse public reaction towards its product. Gap sued Supey for damages. There is a reasonable possibility that Gap will prevail in the suit.

- At December 31, 1990, Supey had a noncancellable purchase contract for 10,000 pounds of Chemical XZ, for delivery in June 1991. Supey does not hedge its contracts. Supey uses this chemical to make Product 2-Y. In December 1990, the U.S. Food and Drug Administration banned the sale of Product 2-Y in concentrated form. Supey will be allowed to sell Product 2-Y in a diluted form; however, it will take at least five years to use the 10,000 pounds of Chemical XZ. Supey believes the sales price of the diluted product will not be sufficient to recover the contract price of Chemical XZ.

Required:

a. In its 1990 financial statements, how should Supey report the toxic waste cleanup? Why is this reporting appropriate?

b. In its 1990 financial statements, how should Supey report the effects of the contract to purchase Chemical XZ? Why is this reporting appropriate?

N-57
<table>
<thead>
<tr>
<th>QUESTIONS 1-3, PAGE 1</th>
</tr>
</thead>
</table>

WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE BLOCKS TO THE LEFT: ONE DIGIT PER BLOCK. THEN COMPLETELY BLACKEN THE CIRCLE IN THE COLUMN WHICH CORRESPOND TO THE DIGIT YOU HAVE WRITTEN IN THE BOX AT THE TOP OF THE COLUMN. MARK ONLY ONE CIRCLE PER COLUMN.

**IMPORTANT DIRECTIONS FOR MARKING ANSWERS**

- Use a No. 2 pencil only.
- Make heavy marks that fill the circle completely.
- *Erase clearly any answer you wish to change.*
- Make no stray marks on this answer sheet.

**EXAMPLES:**

- Wrong
- Wrong
- Wrong
- Right

**APPLICATIONS:**

The scores for the multiple choice questions were determined in accordance with the following scales:

<table>
<thead>
<tr>
<th>Correct</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>13</td>
<td>10</td>
</tr>
<tr>
<td>14</td>
<td>10</td>
</tr>
<tr>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>16</td>
<td>10</td>
</tr>
<tr>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>19</td>
<td>10</td>
</tr>
<tr>
<td>20</td>
<td>10</td>
</tr>
</tbody>
</table>

**CAUTION:**

Answer sheets may vary from examination to examination. It is important to pay exact attention to the manner in which your answer sheet is printed in which you have indicated your answer and the number with the item in your question booklet.
**Accounting Practice — Part I**

**Uniform Certified Public Accountant Examination**

**Accounting Practice — Part I**

**November 1991**

**Candidate No.** ____________________

**State** ____________________

**Question No. 4** Page: __________

**Dey Toys**

**WORKSHEET TO CONVERT**

**TRIAL BALANCE TO ACCRUAL BASIS**

**December 31, 1990**

<table>
<thead>
<tr>
<th>Account Title</th>
<th>Cash Basis</th>
<th>Adjustments</th>
<th>Accrual Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>Cash</td>
<td>8,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>9,000</td>
<td>(1) 8,800</td>
<td>17,800</td>
</tr>
<tr>
<td>Inventory</td>
<td>40,000</td>
<td>(3) 6,000</td>
<td>46,000</td>
</tr>
<tr>
<td>Machinery &amp; equipment</td>
<td>70,000</td>
<td></td>
<td>70,000</td>
</tr>
<tr>
<td>Leasehold improvements</td>
<td>28,800</td>
<td></td>
<td>28,800</td>
</tr>
<tr>
<td>Accumulated depreciation &amp; amort.</td>
<td>18,000</td>
<td>(6) 11,500</td>
<td>29,500</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>9,600</td>
<td>(7) 9,000</td>
<td>18,600</td>
</tr>
<tr>
<td>Payroll taxes withheld</td>
<td>1,700</td>
<td></td>
<td>1,700</td>
</tr>
<tr>
<td>Dey, drawings</td>
<td></td>
<td>(10) 55,800</td>
<td>55,800</td>
</tr>
<tr>
<td>Dey, capital</td>
<td>67,300</td>
<td>(8) 1,600</td>
<td>(5) 11,250</td>
</tr>
<tr>
<td>Allowance for uncollectible accounts</td>
<td>(2) 2,100</td>
<td></td>
<td>2,100</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>1,200</td>
<td></td>
<td>1,200</td>
</tr>
<tr>
<td>Prepaid rent</td>
<td>1,260</td>
<td></td>
<td>12,600</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td></td>
<td>(8) 2,520</td>
<td>2,520</td>
</tr>
<tr>
<td>Estimated liability from lawsuit</td>
<td>35,000</td>
<td></td>
<td>35,000</td>
</tr>
</tbody>
</table>

| Sales                         | 374,000    | (1) 8,800   | 382,800       |
| Purchases                     | 165,400    | (7) 9,000   | 174,400       |
| Salaries                      | 107,000    | (8) 270     | (10) 48,000   | 59,270        |
| Payroll taxes                 | 5,800      | (8) 300     | 6,100         |
| Insurance                     | 4,800      | (4) 120     | 4,680         |
| Dey’s living expenses         | 7,800      | (10) 7,800  |               |
| Rent                          | 16,800     | (5) 1,350   | 15,450        |
| Utilities                     | 7,000      | (8) 350     | 7,350         |
| Income summary — inventory    | 10,000     | (3) 40,000  | (3) 46,000    | 6,000         |
| Depreciation & amortization   |             | (6) 11,500  | 11,500        |
| Uncollectible accounts        |             | (2) 2,100   | 2,100         |
| Estimated loss from lawsuit   |             | (9) 35,000  | 35,000        |

| 470,600 | 470,600 | 184,520 | 184,520 | 556,250 | 556,250 |
Examination Answers — November 1991

Answer 4 (continued)

Explanations of Adjustments

[1] To convert 1990 sales to accrual basis.

Accounts receivable balances:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1990</td>
<td>$17,800</td>
</tr>
<tr>
<td>December 31, 1989</td>
<td>9,000</td>
</tr>
<tr>
<td>Increase in sales</td>
<td>$ 8,800</td>
</tr>
</tbody>
</table>


[3] To record increase in inventory from 12/31/89 to 12/31/90.

Inventory balances:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1990</td>
<td>$46,000</td>
</tr>
<tr>
<td>December 31, 1989</td>
<td>40,000</td>
</tr>
<tr>
<td>Increase in inventory</td>
<td>$ 6,000</td>
</tr>
</tbody>
</table>


Prepaid balances:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1990 ($4,800 \times \frac{3}{12})</td>
<td>$1,200</td>
</tr>
<tr>
<td>December 31, 1989 ($4,320 \times \frac{3}{12})</td>
<td>1,080</td>
</tr>
<tr>
<td>Decrease in insurance expense</td>
<td>$ 120</td>
</tr>
</tbody>
</table>


Prepaid balances:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1990 ($16,800 \times \frac{3}{12})</td>
<td>$12,600</td>
</tr>
<tr>
<td>December 31, 1989 ($15,000 \times \frac{3}{12})</td>
<td>11,250</td>
</tr>
<tr>
<td>Decrease in rent expense</td>
<td>$ 1,350</td>
</tr>
</tbody>
</table>


Cost of leasehold improvement $28,800
Estimated life limited to lease term 8 years
Amortization ($28,800 \times \frac{1}{8} \times \frac{1}{4}) 900
Depreciation expense on machinery and equipment 10,600

$11,500

[7] To convert 1990 purchases to accrual basis.

Accounts payable balances:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 1990</td>
<td>$18,600</td>
</tr>
<tr>
<td>December 31, 1989</td>
<td>9,600</td>
</tr>
<tr>
<td>Increase in purchases</td>
<td>$ 9,000</td>
</tr>
</tbody>
</table>

[8] To convert expenses to accrual basis.

<table>
<thead>
<tr>
<th>Item</th>
<th>December 31, 1990</th>
<th>December 31, 1989</th>
<th>Increase in expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Utilities</td>
<td>$ 850</td>
<td>$ 500</td>
<td>$ 350</td>
</tr>
<tr>
<td>Salaries</td>
<td>770</td>
<td>500</td>
<td>270</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>900</td>
<td>600</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td>$2,520</td>
<td>$1,600</td>
<td>$920</td>
</tr>
</tbody>
</table>


Attorney’s estimate of probable loss $135,000
Amount covered by insurance 100,000
Dey’s estimated liability $ 35,000


Salary $48,000
Living expenses 7,800

$55,800

b. Dey Toys

STATEMENT OF CHANGES IN DEY, CAPITAL
For the Year Ended December 31, 1990

Dey, capital, December 31, 1989 $ 78,030 (1)
Add net income for the year 72,950 (2)

150,980

Deduct drawings for the year 55,800
Dey, capital, December 31, 1990 $ 95,180

Explanation of Amounts

[1] Dey, capital, 12/31/89 after adjustment to accrual basis per worksheet.

[2] Computation of net income on accrual basis for the year ended 12/31/90. (Per worksheet)

Sales $382,800

Purchases $174,400

Income summary-

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Salaries</td>
<td>59,270</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>6,100</td>
</tr>
<tr>
<td>Insurance</td>
<td>4,680</td>
</tr>
<tr>
<td>Rent</td>
<td>15,450</td>
</tr>
<tr>
<td>Utilities</td>
<td>7,350</td>
</tr>
<tr>
<td>Depreciation</td>
<td>11,500</td>
</tr>
<tr>
<td>Uncollectible accounts</td>
<td>2,100</td>
</tr>
<tr>
<td>Provision for lawsuit</td>
<td>35,000</td>
</tr>
</tbody>
</table>

309,850

Net income $ 72,950
Answer 5 (10 points)

Pine Corp.

JOURNAL ENTRIES
March 31, 1990

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in Strand, Inc.</td>
<td>5,400,000</td>
<td>[1]</td>
</tr>
<tr>
<td>Common stock</td>
<td></td>
<td>2,000,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td></td>
<td>970,000  [2]</td>
</tr>
<tr>
<td>Retained earnings of subsidiary</td>
<td></td>
<td>2,430,000</td>
</tr>
<tr>
<td>To record issuance of 200,000 shares of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>common stock for all the outstanding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>common stock of Strand, Inc., in a business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>combination accounted for by the pooling-of-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>interests method.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses of business combination</td>
<td>720,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>720,000</td>
</tr>
<tr>
<td>To record payment of the expenses relating to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>the business combination with Strand, Inc.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Explanations of Amounts

[1] Investment in Strand, Inc.
   Carrying amount of Strand’s stockholders’ equity, March 31, 1990
   Capital stock                                      $2,500,000
   Additional paid-in capital                         470,000
   Retained earnings                                  2,430,000
   Total                                              $5,400,000

   Strand, Inc. additional paid-in capital,
   March 31, 1990                                      $ 470,000
   Par value of Strand, Inc. common stock acquired    $2,500,000
   Par value of Pine Corp. common stock issued        $2,000,000
   (200,000 shares × $10)
   Excess added to additional paid-in capital         500,000
   Total                                              $ 970,000
Answer 5 (continued)

b.  

Pine Corp.
INVESTMENT IN STRAND, INC. — AT EQUITY
December 31, 1990

Balance at date of acquisition, 3/31/90  $5,400,000
Net income of Strand, Inc.
for period 4/1 through 12/31/90  $1,060,000 [3]
Less: Elimination of intercompany profit in Strand’s inventory
200,000  860,000
Balance, 12/31/90  $6,260,000

Explanation of Amounts
for period 4/1 through 12/31/90
Retained earnings, 12/31/89  $2,290,000
Net income for 1990  $1,450,000
Less: Dividend paid, 3/10/90 (250,000)
Net increase in 1990 retained earnings  1,200,000
Retained earnings, 12/31/90  3,490,000
Retained earnings, 3/31/90  (2,430,000)
Net income for period 4/1 through 12/31/90  $1,060,000

Consolidated Statement of Changes in Retained Earnings
For the Year Ended December 31, 1990

Balance, December 31, 1989:
As originally reported  $ 6,820,000
Adjustment for pooling of interests
with Strand, Inc.
As restated  9,110,000
Net income  3,490,000 [4]
12,600,000

Dividends paid:
By Strand, Inc., before combination
By Pine Corp., after combination (250,000) (1,500,000)
(1,750,000)
Balance, December 31, 1990  $10,850,000

Explanation of Amounts
Pine Corp.’s income before considering equity in Strand’s net income  $2,240,000
Strand, Inc.’s separate net income  1,450,000
3,690,000
Elimination of intercompany profit in Strand’s inventory (¼ × $800,000)  (200,000)
Consolidated net income for 1990  $3,490,000

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### Answering Instructions

- Use a No. 2 pencil only.
- Make heavy black marks that fill the circle completely.
- Erase clearly any answer you wish to change.
- Make no stray marks on this answer sheet.

**Examples:**

- **Wrong:**
  - Wrong
  - Wrong
  - Wrong
- **Right:**
  - Right
  - Right
  - Right

**Caution:** Answer sheets may vary from examination to examination. It is important to pay strict attention to the manner in which your answer sheet is structured. As you proceed with the examination, be absolutely certain that the space in which you have indicated your answer corresponds directly in number with the item in your question booklet.

### Score Scales

**Answer 1**

<table>
<thead>
<tr>
<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
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<th>20</th>
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</thead>
<tbody>
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<td>Score</td>
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</table>

**Answer 2**

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<th>20</th>
</tr>
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<tbody>
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<td>3½</td>
<td>4</td>
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</tbody>
</table>

**Answer 3**

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<th>3</th>
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<th>19</th>
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</thead>
<tbody>
<tr>
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<td>3½</td>
<td>4</td>
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<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>
Answer 4 (10 points)

a. 1.  
**DIRECT MATERIALS PRICE VARIANCE**

<table>
<thead>
<tr>
<th>Actual cost</th>
<th>2,400 gallons @ $2.45 per gallon</th>
<th>$5,880</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard cost</td>
<td>2,400 gallons @ $2.50 per gallon</td>
<td>6,000</td>
</tr>
<tr>
<td>Price variance</td>
<td></td>
<td>$120  Favorable</td>
</tr>
</tbody>
</table>

a. 2.  
**DIRECT MATERIALS USAGE VARIANCE**

<table>
<thead>
<tr>
<th>Actual usage</th>
<th>2,400 gallons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard usage:</td>
<td>2,100 gallons</td>
</tr>
<tr>
<td>(-\frac{1,800}{18,000} \times 21,000) feet =</td>
<td>(-\frac{21,000}{18,000}) gallons</td>
</tr>
<tr>
<td>Usage variance</td>
<td>300 gallons @ $2.50</td>
</tr>
</tbody>
</table>

a. 3.  
**DIRECT LABOR TRAVEL, SETUP, AND CLEARUP VARIANCE**

<table>
<thead>
<tr>
<th>Actual cost</th>
<th>300 hours @ $8.00 per hour</th>
<th>$2,400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard cost:</td>
<td>210 customers \times 1 hour each</td>
<td>1,680</td>
</tr>
<tr>
<td>Variance</td>
<td>210 hours @ $8.00 per hour</td>
<td>$720  Unfavorable</td>
</tr>
</tbody>
</table>

a. 4.  
**DIRECT LABOR BONUS**

<table>
<thead>
<tr>
<th>Actual direct labor (tree-spraying)</th>
<th>910 hours @ $8.00 per hour</th>
<th>$7,280</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard direct labor:</td>
<td>(-\frac{900}{18,000} \times 21,000) feet =</td>
<td>(-\frac{900}{18,000}) hours @ $8.00 per hour</td>
</tr>
<tr>
<td>Direct labor efficiency variance</td>
<td>1,050 hours @ $8.00 per hour</td>
<td>8,400</td>
</tr>
<tr>
<td>Incentive</td>
<td>\times .75</td>
<td></td>
</tr>
<tr>
<td>Bonus</td>
<td></td>
<td>$840</td>
</tr>
</tbody>
</table>

a. 5.  
**OVERHEAD SPENDING VARIANCE**

| Actual overhead               | $5,400 |
| Standard overhead:            |       |
| Variable                      | $1,260 |
| 210 customers \times ($1,200/200) |       |
| 21,000 feet \times ($1,800/18,000) | 2,100 |
| Fixed                         | 2,000  |
| Spending variance             | 5,360  |
|                               | $40    Unfavorable |
Answer 4 (continued)

b. ANALYSIS TO DETERMINE ADVISABILITY OF HIRING AN ADDITIONAL EMPLOYEE

Direct labor costs of overtime for current employees

Estimated increase in volume:
20 additional customers with 70% probability 14
30 additional customers with 30% probability 9

Weighted average number of new customers 23

Travel, setup, and cleanup
1 hour for each of 23 new customers 23.0

Tree-spraying
4.5 hours for each of 23 new customers 103.5

Total overtime hours 126.5

Total direct labor overtime costs
126.5 hours \times $8 per hour \times 1.25 \text{ (for 25\% overtime premium)} $1,265

vs.

Costs of hiring an additional employee

Variable (165 hours at $8 per hour) $1,320
Fixed 100

Total costs of hiring an additional employee $1,420

This analysis demonstrates that it would not be cost effective for Tredoc to hire an additional employee.
### Examinations Answers — November 1991

#### Answer 5 (10 points)

**Eden Township**

**ADMINISTRATION CENTER CAPITAL PROJECTS FUND**

*Journal Entries*

*July 1, 1990 to June 30, 1991*

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
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</thead>
<tbody>
<tr>
<td><strong>1990</strong></td>
<td></td>
<td></td>
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<tr>
<td>July 1</td>
<td>Cash</td>
<td>$300,000</td>
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<tr>
<td></td>
<td>Due to general fund</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>To record loan received from general fund</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Expenditures</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record unencumbered expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 1</td>
<td>Cash</td>
<td>6,060,000</td>
<td>6,060,000</td>
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<tr>
<td></td>
<td>Other financing sources</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record sale of bonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Due from state government</td>
<td>3,000,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>Revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record grant due from state</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>1991</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Apr. 30</td>
<td>Encumbrances</td>
<td>7,000,000</td>
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<tr>
<td></td>
<td>Reserved for encumbrances</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record encumbrance for contract</td>
<td></td>
<td></td>
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<tr>
<td>May 9</td>
<td>Cash</td>
<td>1,000,000</td>
<td>1,000,000</td>
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<tr>
<td></td>
<td>Due from state government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record receipt of grant</td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 10</td>
<td>Due to general fund</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To record payment of loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Reserved for encumbrances</td>
<td>1,200,000</td>
<td>1,200,000</td>
</tr>
<tr>
<td></td>
<td>Encumbrances</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>To reverse encumbrance for progress billing on contract</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Expenditures</td>
<td>1,200,000</td>
<td>1,152,000</td>
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<tr>
<td></td>
<td>Contracts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Retainage payable</td>
<td>48,000</td>
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</tr>
<tr>
<td></td>
<td>To record expenditures on construction contract and retained amount</td>
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N-66
b.  

Eden Township  
ADMINISTRATION CENTER CAPITAL PROJECTS FUND  
Closing Entries  
June 30, 1991

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
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<tbody>
<tr>
<td>Fund balance</td>
<td>$7,200,000</td>
<td>$5,800,000</td>
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<tr>
<td>Encumbrances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td>1,400,000</td>
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<tr>
<td>To close</td>
<td></td>
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</tbody>
</table>

(2)

<table>
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<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
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<tr>
<td>Revenues</td>
<td>3,000,000</td>
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<tr>
<td>Other financing sources</td>
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<td>9,060,000</td>
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<tr>
<td>Fund balance</td>
<td></td>
<td></td>
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<tr>
<td>To close</td>
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<td></td>
</tr>
</tbody>
</table>

c.  

Eden Township  
ADMINISTRATION CENTER CAPITAL PROJECTS FUND  
BALANCE SHEET  
June 30, 1991

**Assets**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$6,860,000</td>
</tr>
<tr>
<td>Due from state government</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$8,860,000</td>
</tr>
</tbody>
</table>

**Liabilities and Fund Balance**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts payable</td>
<td>$1,152,000</td>
</tr>
<tr>
<td>Retainage payable</td>
<td>48,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Fund balance:</td>
<td></td>
</tr>
<tr>
<td>Reserved for encumbrances</td>
<td>5,800,000</td>
</tr>
<tr>
<td>Unreserved — designated for construction</td>
<td>1,860,000</td>
</tr>
<tr>
<td>Total fund balance</td>
<td>7,660,000</td>
</tr>
<tr>
<td>Total liabilities and fund balance</td>
<td>$8,860,000</td>
</tr>
</tbody>
</table>
UNIFORM CERTIFIED PUBLIC ACCOUNTANT EXAMINATION
NOVEMBER 1991 ANSWER SHEET

AUDITING

WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE BLOCKS TO THE LEFT: ONE DIGIT PER BLOCK.
THEN COMPLETELY BLACKEN THE CIRCLE IN THE COLUMN WHICH CORRESPONDS TO THE DIGIT YOU HAVE WRITTEN IN THE BOX AT THE TOP OF THE COLUMN. MARK ONLY ONE CIRCLE PER COLUMN.

IMPORTANT DIRECTIONS FOR MARKING ANSWERS
• Use a No. 2 pencil only.
• Make heavy black marks that fill the circle completely.
• Erase clearly any answer you wish to change.
• Make no stray marks on this answer sheet.

EXAMPLES:
1 O O O O O O
2 O O O O O O
3 O O O O O O
4 O O O O O O
5 O O O O O O
6 O O O O O O
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96 O O O O O O
97 O O O O O O
98 O O O O O O
99 O O O O O O
100 O O O O O O

IT WOULD BE TO YOUR ADVANTAGE TO ANSWER ALL QUESTIONS

The scores for the multiple choice questions were determined in accordance with the following scales:

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<thead>
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<th>Correct</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
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<td>19</td>
<td>20</td>
<td>21</td>
<td>22</td>
<td>23</td>
</tr>
</tbody>
</table>

| 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 |

<table>
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<th>42</th>
<th>43</th>
<th>44</th>
<th>45</th>
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<th>47</th>
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<th>51</th>
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<td>59</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
</tbody>
</table>
Answer 2 (10 points)

1. Statement 1 is appropriate.
2. Statement 2 is appropriate.
3. Statement 3 is not appropriate because the auditors are required to plan and perform the audit to provide reasonable assurance of detecting instances of noncompliance having a direct and material effect on the financial statements, not all instances of noncompliance.
4. Statement 4 is appropriate.
5. Statement 5 is not appropriate because rendering an opinion is a higher level of reporting than the positive and negative assurance required by Government Auditing Standards.
6. Statement 6 is appropriate.
7. Statement 7 is not appropriate because negative assurance applies to items not tested.
8. Statement 8 is not appropriate because Government Auditing Standards require that, unless restricted by law or regulation, copies of the reports should be made available for public inspection.
Answer 3 (10 points)

The control environment factors (excluding the factor illustrated in the example) that establish, enhance, or mitigate the effectiveness of specific policies and procedures, and their components are

Organizational Structure
An entity’s organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity’s organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee/Board of Directors
An effective audit committee takes an active role in overseeing an entity’s accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity’s external and internal auditors.

Methods of Assigning Authority and Responsibility
These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

• Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
• Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
• Employee job descriptions delineating specific duties, reporting relationships, and constraints.
• Computer systems documentation indicating the procedures for authorizing transactions and approving system changes.

Internal Audit Function
The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.

Management Control Methods
These methods affect management’s direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

• Establishing planning and reporting systems that set forth management’s plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
• Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
• Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
• Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Personnel Policies and Practices
These policies and practices affect an entity’s ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity’s policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences
These are influences established and exercised by parties outside an entity that affect an entity’s operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity’s authority. Such influences, however, may heighten management’s consciousness of and attitude towards the conduct and reporting of an entity’s operations and may also prompt management to establish specific internal control structure policies or procedures.
## Answer 4 (10 points)

### a.

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<tr>
<th><strong>Primary Assertion</strong></th>
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<tr>
<td>4. Existence or occurrence</td>
<td>To determine that the custodian holds the securities as identified in the confirmation.</td>
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<td>5. Completeness</td>
<td>To determine that all income and related collections from the investments are properly recorded.</td>
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<td>6. Valuation or allocation</td>
<td>To determine that the market or other value of the investments is fairly stated.</td>
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<td>7. Presentation and disclosure</td>
<td>To determine that the financial statement presentation and disclosure of investments is in conformity with generally accepted accounting principles consistently applied.</td>
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<tr>
<td>8. Valuation or allocation</td>
<td>To determine that the market or other value of the investments is fairly stated and the loss is properly recognized and recorded.</td>
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### b.

Larkin should consider applying the following additional substantive auditing procedures in auditing Vernon's investments:

- Inspect securities on hand in the presence of the custodian.
- Examine supporting evidence (broker's advices, etc.) for transactions between the balance sheet date and the inspection date.
- Obtain confirmation from the issuers or trustees for investments in nonpublic entities.
- Examine contractual terms of debt securities and preferred stock.
- Determine that sales and purchases were properly approved by the Board of Directors or its designee.
- Examine broker's advices in support of transactions or confirm transactions with broker.
- Determine that gains and losses on dispositions have been properly computed.
- Trace payments for purchases to canceled checks, and proceeds from sales to entries in the cash receipts journal.
- Determine that the amortization of premium and discount on bonds has been properly computed.
- Determine that market value for both current and long-term portfolios has been properly computed by tracing quoted market prices to competent published or other sources.
- Compute the unrealized gains and losses on both current and long-term portfolios for marketable equity securities.
- Determine that the unrealized gains and losses on the current portfolio have been properly classified in the income statement, and the unrealized gains and losses on the noncurrent portfolio have been properly classified in the equity section of the balance sheet.
- Ascertain whether any investments are pledged as collateral or encumbered by liens, and, if so, are properly disclosed.
Answer 5 (10 points)

1. Statistical sampling does not eliminate the need for professional judgment.

2. The tolerable rate of deviation or acceptable upper precision limit (UPL) is too high (20%) if Baker plans to assess control risk at a low level (substantial reliance).

3. Discovery sampling is not an appropriate sampling technique in this attribute sampling application.

4. The sampling technique employed is not discovery sampling.

5. The increase in the population size has little or no effect on determining sample size.

6. Baker failed to consider the allowable risk of assessing control risk too low (risk of overreliance) in determining the sample size.

7. The population from which the sample was chosen (invoices) was an incorrect population.

8. The sample selected was not randomly selected.

9. Baker failed to consider the difference of an immaterial amount to be an error.

10. The allowance for sampling risk was incorrectly calculated.

11. Baker's reasoning concerning the decision that the sample supported a low assessed level of control risk was erroneous.
IT WOULD BE TO YOUR ADVANTAGE TO ANSWER ALL QUESTIONS

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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 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
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N-73
**Answer 2 (10 points)**

Bradley would be successful in the suit against Frost and Glen for failing to vote Bradley to the board of directors. The stockholders have the right to elect the directors of a corporation. The stockholders have the right to agree among themselves on how they will vote. Therefore, the voting provision of the stockholders’ agreement between Bradley, Frost, and Glen is enforceable.

Bradley would be unsuccessful in attempting to be reinstated as vice president. A corporation’s board oversees the operations of the business, which includes hiring officers and, at its discretion, dismissing officers with or without cause. Bradley would be successful in collecting some damages for the breach of the employment contract because there was no demonstrated cause for Bradley’s dismissal.

Bradley would be successful in having Frost and Glen held personally liable to the corporation for declaring and paying the dividend because payment of a dividend that threatens a corporation’s solvency is unlawful. Ordinarily, directors who approve such a dividend would be personally liable for its repayment to the corporation. However, the directors, other than Frost and Glen, in relying on the assurances and information supplied by Frost and Glen, as corporate officers, are protected by the business judgment rule. Therefore, only Frost and Glen would be held personally liable.

**Answer 3 (10 points)**

Stake’s first allegation, that Packer committed fraud in the formation of the contract, is correct and Stake may rescind the contract. Packer had assured Stake that the vacant parcel would be used for a shopping center when, in fact, Packer intended to use the land to construct apartment units that would be in direct competition with those owned by Stake. Stake would not have sold the land to Packer had Packer’s real intentions been known. Therefore, the elements of fraud are present:

- A false representation;
- Of a fact;
- That is material;
- Made with knowledge of its falsity and intention to deceive;
- That is justifiably relied on.

Stake’s second allegation, that the mistake as to the fair market value of the land entitles Stake to rescind the contract, is incorrect. Generally, mistakes as to adequacy of consideration or fairness of a bargain are insufficient grounds to entitle the aggrieved party to rescind a contract.

Stake’s third allegation, that the contract was not enforceable against Stake because Stake did not sign the counteroffer, is correct. The contract between Stake and Packer involves real estate and, therefore, the Statute of Frauds requirements must be satisfied. The Statute of Frauds requires that a writing be signed by the party against whom enforcement is sought. The counteroffer is unenforceable against Stake, because Stake did not sign it. As a result, Stake is not obligated to sell the land to Packer under the terms of the counteroffer.
Business Law

Answer 4 (10 points)

a. 1. Vesta Electronics would bear the risk of loss for the 18" speakers destroyed by the fire on its loading dock. Even though Vesta identified and segregated the goods on its loading dock, the risk of loss remained with the seller because the contract's shipping terms "F.O.B. seller's loading dock" made it a shipping contract. Thus, risk of loss does not pass to Zap until the goods are delivered to the carrier.

2. The risk of loss for the 16" speakers also remained with Vesta. Even though the goods were delivered to the common carrier, risk of loss did not pass because Vesta shipped nonconforming goods.

b. 1. Zap may validly reject the 16" speakers because any buyer may reject nonconforming goods. To avoid potential liability, the rejection must be made within a reasonable time of receipt and must be communicated to the seller.

2. Zap may also validly accept some of the 18" speakers. A buyer may accept none, all, or any commercial unit of a shipment when nonconforming goods are shipped.

c. To be entitled to damages, Zap must comply with the UCC by notifying Vesta of the rejection of the goods within a reasonable time; acting in good faith with respect to the rejected goods by following any reasonable instructions of the seller; and giving Vesta the opportunity to cure until the contract time of performance expires.

Answer 5 (10 points)

Rice's assertion that Abco does not have an effective security interest in the CDM computer purchased by Rice is correct. For Abco to have an enforceable security interest in the collateral, the security interest claimed must have attached. Attachment requires that:

- The secured party (Abco) has given value;
- The debtor (Rice) has rights in the collateral; and
- The debtor (Rice) has executed and delivered to the creditor (Abco) a security agreement covering the collateral.

In this case, all but one of the requirements are met. The security agreement is ineffective because it was not signed by the debtor (Rice). Abco's failure to perfect its security interest by filing a financing statement would have no effect on the enforceability of the security interest against Rice.

Condor's assertion that its security interest in the computer is superior to Abco's is incorrect. Both Condor's and Abco's security interests are perfected. Condor's security interest was perfected when it filed its financing statement on August 26. Because Abco's security interest was a purchase money security interest in collateral other than inventory, its security interest was perfected at the time of the sale to Baker (August 18), provided it filed a financing statement at the time Baker took possession of the computer or within the UCC time period for perfection. Abco's security interest was perfected on August 18 before Condor's was perfected (on August 26), because Abco filed a financing statement within the applicable UCC time period. Therefore, Abco's security interest is superior to Condor's.
**ACCOUNTING THEORY**
*(THEORY OF ACCOUNTS)*

**WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE BLOCKS TO THE LEFT: ONE DIGIT PER BLOCK.**

*IMPORTANT DIRECTIONS FOR MARKING ANSWERS*
- Use a No. 2 pencil only.
- Make heavy black marks that fill the circle completely.
- Make no stray marks on this answer sheet.

**EXAMPLES:**

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**CAUTION:** Answer sheets may vary from examination to examination. It is important to pay strict attention to the manner in which your answer sheet is structured. As you proceed with the examination, be absolutely certain that the space in which you have indicated your answer corresponds directly in number with the item in your question booklet.

**IT WOULD BE TO YOUR ADVANTAGE TO ANSWER ALL QUESTIONS**

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The scores for the multiple choice portion were determined using the following scale:

| Correct | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
|---------|---|---|---|---|---|---|---|---|---|---|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 0 | 11| 12| 13| 14| 15| 16| 17| 18| 19| 20 | 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 |

| Correct | 21 | 22 | 23 | 24 | 25 | 26 | 27 | 28 | 29 | 30 | 31 | 32 | 33 | 34 | 35 | 36 | 37 | 38 | 39 | 40 |
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| Score   | 31 | 32 | 33 | 34 | 35 | 36 | 37 | 38 | 39 | 40 | 41 | 42 | 43 | 44 | 45 | 46 | 47 | 48 | 49 | 50 |

| Correct | 41 | 42 | 43 | 44 | 45 | 46 | 47 | 48 | 49 | 50 | 51 | 52 | 53 | 54 | 55 | 56 | 57 | 58 | 59 | 60 |
|---------|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|----|
| Score   | 51 | 52 | 53 | 54 | 55 | 56 | 57 | 58 | 59 | 60 | 60 | 60 | 60 | 60 | 60 | 60 | 60 | 60 | 60 | 60 |

N-76
Accounting Theory

Answer 2 (10 points)

a. 1. It was not possible to determine the machine's fair value directly, so the sales price of the machine is reported at the note's September 30, 1989, fair value. The note's September 30, 1989, fair value equals the present value at that date of the two installments discounted at the buyer's September 30, 1989, market rate of interest from their due dates of September 30, 1990, and September 30, 1991.

2. Industrial reports 1989 interest revenue determined by multiplying the note's carrying amount at September 30, 1989, times the buyer's market rate of interest at the date of issue, times three-twelfths. Industrial should recognize that there is an interest factor implicit in the note, and this interest is earned with the passage of time. Therefore, interest revenue for 1989 should include three months' revenue. The rate used should be the market rate established by the original present value, and this is applied to the carrying amount of the note.

b. To report the discounting of the note receivable with recourse, Industrial should decrease notes receivable by the carrying amount of the discounted note, increase cash by the amount received, and report the difference as a loss or gain as part of income from continuing operations. The contingent liability with respect to a possible customer default should be disclosed in notes to the financial statements.

c. Industrial should decrease cash, and increase its notes (accounts) receivable past due for all payments caused by the note's dishonor. The note (account) receivable should be written down to its estimated recoverable amount (or an allowance for uncollectibles established), and a loss on uncollectible notes should be recorded for the difference.

Answer 3 (10 points)

a. Portland should have selected the straight-line depreciation method when approximately the same amount of an asset's service potential is used up each period. If the reasons for the decline in service potential are unclear, then the selection of the straight-line method could be influenced by the ease of record keeping, its use for similar assets, and its use by others in the industry.

b. Portland should record depreciation expense to the date of the exchange. If the original truck's carrying amount is greater than its fair value, a loss results. The truck's capitalized cost and accumulated depreciation are eliminated, and the loss on trade-in is reported as part of income from continuing operations. The newly acquired truck is recorded at fair value. If the original truck's carrying amount is less than its fair value at trade-in, then there is an unrecognized gain. The newly acquired truck is recorded at fair value less the unrecognized gain. Cash is decreased by the amount paid.

c. 1. By associating depreciation with a group of machines instead of each individual machine, Portland's bookkeeping process is greatly simplified. Also, since actual machine lives vary from the average depreciable life, unrecognized net losses on early dispositions are expected to be offset by continuing depreciation on machines usable beyond the average depreciable life. Periodic income does not fluctuate as a result of recognizing gains and losses on manufacturing machine dispositions.

2. Portland should divide the depreciable cost (capitalized cost less residual value) of each machine by its estimated life to obtain its annual depreciation. The sum of the individual annual depreciation amounts should then be divided by the sum of the individual capitalized costs to obtain the annual composite depreciation rate.
**Answer 4 (10 points)**

a. 1. Notes to Supey’s 1990 financial statements should disclose the nature of the loss on cleanup and indicate that an estimate of the loss, or range of the loss, cannot be made. No accrual should be made because the loss cannot be reasonably estimated and accrual of an uncertain amount would impair the integrity of the financial statements.

2. Supey should disclose the nature of Gap’s claim in the notes to the 1990 financial statements. Disclosure should include an estimate of the potential loss. Supey should not accrue the loss because it is only reasonably possible that it will have to pay for Gap’s losses.

b. An estimated loss on the purchase commitment, equal to the unrecoverable amount of the contract price, should be reported as part of 1990 income from continuing operations and as a current liability at December 31, 1990. The net loss on the purchase commitment should be measured and recognized in the period in which it occurs. Since Supey did not hedge this contract, reporting this loss recognizes the commitment’s impact on future cash flows.

**Answer 5 (10 points)**

a. Segment disclosures assist in analyzing and understanding financial statements by permitting better assessment of past performance and future prospects. Disaggregated information provides more precise details of the uncertainties surrounding the timing and the amount of expected cash flows, because the various segments may have different rates of profitability, degrees and types of risk, opportunities for growth, and future capital demands.

b. Barnet should have reported an industry segment that satisfies one or more of the following tests:

1. The segment’s revenue, including both sales to unaffiliated customers and intersegment sales or transfers, is 10% or more of the combined revenue of all Barnet’s industry segments.

2. The segment’s absolute amount of operating profit or loss is 10% or more of the greater in absolute amount of:
   - The combined operating profit of all industry segments with operating profits, or
   - The combined operating loss of all industry segments with operating losses.

3. The segment’s identifiable assets are 10% or more of the combined identifiable assets of all industry segments.

c. Barnet’s 1991 income statement should report the results of discontinued boating operations separately and immediately below income from continuing operations. Discontinued boating operations should be composed of the following two categories, with each category shown net of income taxes:

   • Profit from operations for the period January 1 to July 31, 1991.

   • Loss on disposal equal to the expected loss on the boating asset sale, less the profits earned and expected to be earned for the period August 1, 1991, through February 28, 1992.
SUGGESTED REFERENCES

November 1991

Accounting Practice — Part I

Numbers 1, 2 and 3

Danos and Imhoff, Intermediate Accounting (Prentice-Hall, 1983).
FASB, Accounting Standards, Current Text (FASB).
Griffin, Williams, Larson, Boatsman, and Bell, Advanced Accounting, 5th ed. (Irwin, 1985).

Number 4

AICPA, Accounting Principles Board Opinion No. 20, Accounting Changes (AICPA, 1971).

Number 5

AICPA, Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (AICPA, 1971).
Fischer, Taylor, and Leer, Advanced Accounting, 4th ed. (South-Western, 1990), pp. 188-189.
Griffin, Williams, Larson, Boatsman, and Bell, Advanced Accounting, 5th ed. (Irwin, 1985), pp. 185, 186.
Suggested References

Accounting Practice — Part II

Number 1


Number 2

A standard tax service, the Internal Revenue Code, Income Tax Regulations, and Estate and Gift Tax Regulations.

Number 3

A standard tax service, the Internal Revenue Code, and Income Tax Regulations.

Number 4


Number 5

Suggested References

Auditing

Number 1

AICPA, Auditing Procedure Study, Audit of Inventories (AICPA, 1986).
AICPA, Codification of Statements on Auditing Standards nos. 1 to 63 (Commerce Clearing House, 1990).
AICPA, Codification of Statements on Auditing Standards for Accounting and Review Services nos. 1 to 6 (Commerce Clearing House, 1989).
Cook and Winkle, Auditing, 4th revised ed. (Houghton Mifflin, 1988).
Davis, Adams, and Schaller, Auditing and EDP, 2d ed. (AICPA, 1983).

Number 2

AICPA, Codification of Statements on Auditing Standards, nos. 1 to 63 (Commerce Clearing House, 1990), sec. 801.

Number 3

AICPA, Audit and Accounting Manual, Nonauthoritative Practice Aids (Commerce Clearing House, 1990), secs. 4400.050 to 4400.110.
AICPA, Codification of Statements on Auditing Standards, nos. 1 to 63 (Commerce Clearing House, 1990), sec. 319.

Number 4

AICPA, Audit and Accounting Manual, Nonauthoritative Practice Aids (Commerce Clearing House, 1990), sec. 5400.060.
AICPA, Codification of Statements on Auditing Standards, nos. 1 to 63 (Commerce Clearing House, 1990), secs. 326 and 332.
Robertson, Auditing, 6th ed. (Irwin, 1990), chap. 17.

Number 5

AICPA, Codification of Statements on Auditing Standards, nos. 1 to 63 (Commerce Clearing House, 1990), sec. 350.
Suggested References

Business Law

Number 1

Internal Revenue Code, secs. 6107(b), 6695.
Uniform Commercial Code, secs. 2-721, 3-407, 3-411, 3-502.

Number 2


Number 3


Number 4


Number 5

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).
Usry and Hammer, Cost Accounting: Planning and Control, 10th ed. (South-Western, 1991).

Number 2

AICPA, Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables (AICPA, 1971), pars. 12-3.

Number 3

AICPA, Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions (AICPA, 1973), pars. 21-2.

Number 4

AICPA, Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (AICPA, 1953), chap. 4, par. 17.
FASB, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FASB, 1975), pars. 8, 10.

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 .................................................1M(N-2)
   B. Income Statement ............................................2M(N-2)
   C. Statement of Cash Flows .................................5M(N-3),6M(N-3),7M(N-3)
   D. Statement of Owners’ Equity ............................4(N-12)
   E. Consolidated Financial Statements or Worksheets ......5(N-14)

II. Measurement, Valuation, Realization, and Presentation
    of Assets in Conformity With Generally Accepted Accounting
    Principles.
   A. Cash, Marketable Securities, and Investments ........3M(N-2),8M(N-3),9M(N-3)
   B. Receivables and Accruals .................................10M(N-4),11M(N-4),17M(N-4)
   C. Inventories ..................................................12M(N-4),13M(N-4)
   D. Property, Plant, and Equipment Owned or Leased .....14M(N-4),15M(N-4),16M(N-4),18M(N-5),19M(N-5)
   E. Intangibles and Other Assets ............................4M(N-2),20M(N-5)

III. Valuation, Recognition, and Presentation of Liabilities
     in Conformity With Generally Accepted Accounting
     Principles.
   A. Payables and Accruals ......................................21M(N-5),22M(N-5),23M(N-5),25M(N-6),26M(N-6)
   B. Deferred Revenues ..........................................27M(N-6),29M(N-6)
   C. Deferred Income Tax Liabilities .........................30M(N-6),32M(N-7),35M(N-7),38M(N-8)
   D. Capitalized Lease Liability ..............................33M(N-7),34M(N-7)
   E. Bonds Payable ...............................................24M(N-5),28M(N-6),36M(N-7),37M(N-7)
   F. Contingent Liabilities and Commitments ...............39M(N-8)

IV. Ownership Structure, Presentation, and Valuation of
    Equity Accounts in Conformity With Generally Accepted
    Accounting Principles.
   A. Preferred and Common Stock .............................1M(N-16),3M(N-16)
   B. Additional Paid-in Capital ............................... 
   C. Retained Earnings and Dividends .......................2M(N-16),4M(N-16),5M(N-16),6M(N-17),9M(N-17)
   D. Treasury Stock and Other Contra Accounts ............7M(N-17),13M(N-18)
   E. Stock Options, Warrants, and Rights ...................
   F. Reorganization and Change in Entity ....................8M(N-17),10M(N-17)
   G. Partnerships ............................................11M(N-17),12M(N-17)

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## 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), 40M(N-8), 41M(N-8), 42M(N-8), 43M(N-8), 44M(N-9), 46M(N-9), 49M(N-10), 52M(N-10), 58M(N-11)
- **B.** Expenses and Losses ....................................................... 47M(N-9), 50M(N-10), 53M(N-10), 54M(N-10), 55M(N-11), 57M(N-11)
- **C.** Provision for Income Tax .................................................. 48M(N-9), 59M(N-11)
- **D.** Recurring Versus Nonrecurring Transactions and Events .......... 45M(N-9), 51M(N-10)
- **E.** Accounting Changes ....................................................... 56M(N-11)
- **F.** Earnings Per Share .......................................................... 60M(N-11)

### 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 .............................. 18M(N-18), 19M(N-19)
- **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 .......................................................... 4(N-24)
- **B.** Types of Funds and Account Groups ................................
- **C.** Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations .......... 4(N-24)
- **D.** Various Types of Not-for-Profit and Governmental Organizations ........................................

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Accounting Practice — Content Specification Outline (cont.)

IX. Federal Taxation — Individuals, Estates, and Trusts.

A. Inclusions for Gross Income and Adjusted Gross Income ........................................28M(N-20),30M(N-20),31M(N-20)
B. Exclusions and Adjustments to Arrive at Adjusted Gross Income .....................................
C. Gain or Loss on Property Transactions ..................................33M(N-20)
D. Deductions from Adjusted Gross Income ..............21M(N-19),29M(N-20),32M(N-20),34M(N-20), 35M(N-20),36M(N-21)
E. Filing Status and Exemptions .....................................................
F. Tax Computations and Credits ............................................22M(N-19)
G. Statute of Limitations ............................................................... 20

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

A. Determination of Taxable Income or Loss .................41M(N-21),42M(N-21),43M(N-21),44M(N-21), 45M(N-22),46M(N-22),47M(N-22),48M(N-22), 49M(N-22),50M(N-22)
B. Tax Computations and Credits .............................................51M(N-22),52M(N-22)
C. S Corporations ..........................................................57M(N-23)
D. Personal Holding Companies ...........................................
E. Accumulated Earnings Tax ...........................................
F. Distributions .................................................................
G. Tax-Free Incorporation ......................................................
H. Reorganizations ..............................................................
I. Liquidations and Dissolutions ........................................58M(N-23)
J. Formation of Partnership ..................................................56M(N-23)
K. Basis of Partner’s Interest ................................................59M(N-23),60M(N-23)
L. Determination of Partner’s Taxable Income and Partner’s Elections ........................................55M(N-23)
M. Accounting Periods of Partnership and Partners .......
N. Partner Dealing With Own Partnership ..........................
O. Treatment of Liabilities ....................................................
P. Distribution of Partnership Assets .................................54M(N-23)
Q. Termination of Partnership ..............................................
R. Types of Organizations ....................................................
S. Requirements for Exemption ............................................53M(N-23)
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   A. General Standards and Code of Professional Conduct ............................................. 1M(N-27),3M(N-27),4M(N-27),5M(N-27),6M(N-27),7M(N-28),8M(N-28)
   B. Control of the Audit ................................................................................................. 1M(N-27),3M(N-27),4M(N-27),5M(N-27),6M(N-27),7M(N-28),8M(N-28)
   C. Other Responsibilities ............................................................................................... 10M(N-28),11M(N-28),12M(N-28),13M(N-28),14M(N-28),15M(N-28)

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   A. Definitions and Basic Concepts ................................................................................ 32M(N-30),33M(N-31)
   B. Consideration of the Internal Control Structure ...................................................... 34M(N-31),35M(N-31),36M(N-31),3(N-34)
   C. Cycles ....................................................................................................................... 38M(N-31),39M(N-31),40M(N-31),41M(N-31)
   D. Other Considerations ................................................................................................. 43M(N-32),5(N-36)

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      26M(N-30),27M(N-30),28M(N-30),29M(N-30),2(N-34)
   B. Other Reporting Considerations .............................................................................. 20M(N-29),30M(N-30),31M(N-30)
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   C. Workpapers, Privileged Communication, and Confidentiality ........................................ 10M(N-39)

II. Business Organizations.
   A. Agency .......................................................................................................................... 11M(N-39), 12M(N-39), 13M(N-39)
   B. Partnerships and Joint Ventures .............................................................................. 14M(N-39), 15M(N-39), 16M(N-40), 17M(N-40)
   C. Corporations .................................................................................................................. 2(N-45)
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   A. Offer and Acceptance .................................................................................................... 3(N-45)
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   D. Statute of Frauds .......................................................................................................... 3(N-45)
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   G. Mistake and Misrepresentation .................................................................................... 3(N-45)
   H. Parol Evidence Rule .................................................................................................... 23M(N-40)
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   J. Assignments ................................................................................................................... 25M(N-40)

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      35M(N-41), 36M(N-41), 37M(N-41), 38M(N-41), 39M(N-42), 40M(N-42), 41M(N-42), 42M(N-42),
      43M(N-42), 44M(N-42), 45M(N-43)

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   A. Regulation of Employment ............................................................................................ 32M(N-41), 33M(N-41), 34M(N-41)
   B. Federal Securities Acts .................................................................................................. 27M(N-41), 28M(N-41), 29M(N-41), 30M(N-41), 31M(N-41), 32M(N-41), 33M(N-41),
      34M(N-41), 35M(N-41), 36M(N-41), 37M(N-41), 38M(N-41), 39M(N-42), 40M(N-42), 41M(N-42), 42M(N-42),
      43M(N-42), 44M(N-42), 45M(N-43)

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   B. Conceptual Framework ........................................... 1M(N-48)
   C. Basic Concepts and Accounting Principles .......... 2(N-56),3(N-56),4(N-57),5(N-57)
   D. Nature and Purpose of Basic Financial Statements .... 2(N-56),3(N-56),4(N-57),5(N-57)
   E. Consolidated Financial Statements ..................... 9M(N-49)
   F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts ............. 7M(N-49)

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With GAAP.
   A. Cash, Marketable Securities, and Investments .......... 2(N-56),3(N-56),36M(N-52)
   B. Receivables and Accruals .......................................... 2(N-56),6M(N-48)
   C. Inventories ........................................................... 27M(N-51),28M(N-51)
   D. Property, Plant, and Equipment Owned or Leased ... 3(N-56),33M(N-52)
   E. Intangibles and Other Assets ................................. 13M(N-49)

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With GAAP.
   A. Payables and Accruals .............................................. 31M(N-51)
   B. Deferred Revenues ................................................. 19M(N-50)
   C. Deferred Income Tax Liabilities ......................... 4M(N-48)
   D. Capitalized Lease Liability .................................. 34M(N-52)
   E. Bonds Payable ..................................................... 35M(N-52),37M(N-52)
   F. Contingent Liabilities and Commitments ................ 4(N-57)

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With GAAP.
   A. Preferred and Common Stock ................................. 40M(N-53)
   B. Additional Paid-in Capital .....................................
   C. Retained Earnings and Dividends ......................... 25M(N-51)
   D. Treasury Stock and Other Contra Accounts ......... 39M(N-52)
   E. Stock Options, Warrants, and Rights .................. 38M(N-52)
   F. Reorganization and Change in Entity ....................
   G. Partnerships .......................................................... 15M(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-56),5M(N-49),10M(N-49),14M(N-49),20M(N-50)
   B. Expenses and Losses ............................................ 2(N-56),3(N-56),4(N-57),18M(N-50),29M(N-51), 32M(N-52)
   C. Provision for Income Tax .................................... 3M(N-48)
   D. Recurring Versus Nonrecurring Transactions and Events ........................................... 5(N-57),23M(N-50)
   E. Accounting Changes ............................................ 26M(N-51)
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Accounting Theory — Content Specification Outline (cont.)

VI. Other Financial Topics.
   A. Statement of Cash Flows ........................................... 21M(N-50),22M(N-50)
   B. Accounting Policies ................................................
   C. Accounting Changes ................................................. 24M(N-51)
   D. Nonmonetary Transactions ......................................... 3(N-56)
   E. Business Combinations ............................................ 11M(N-49),12M(N-49)
   F. Interim Financial Statements ................................... 2M(N-48)
   G. Gain Contingencies ...................................................
   H. Segments and Lines of Business ............................... 5(N-57)
   I. Employee Benefits .................................................. 30M(N-51)
   J. Analysis of Financial Statements ............................. 17M(N-50)
   K. Development Stage Enterprises .................................
   L. Personal Financial Statements .................................
   M. Combined Financial Statements ............................... 8M(N-49)

VII. Cost Accumulation, Planning, and Control.
   A. Nature of Cost Elements ......................................... 41M(N-53)
   B. Process and Job Order Costing ............................... 43M(N-53)
   C. Standard Costing .................................................... 42M(N-53)
   D. Joint and By-Product Costing, Spoilage, Waste, and Scrap .................................................. 44M(N-53)
   E. Absorption and Variable Costing .......................... 45M(N-53)
   F. Budgeting and Flexible Budgeting ........................ 46M(N-53)
   G. Breakeven and Cost-Volume-Profit Analysis .......... 47M(N-53)
   H. Capital Budgeting Techniques ............................... 49M(N-54)
   I. Performance Analysis ............................................. 50M(N-54)
   J. Other ......................................................................... 48M(N-54)

VIII. Not-for-Profit and Governmental Accounting.
   A. Conceptual Framework .......................................... 51M(N-54)
   B. Fund Accounting ..................................................... 52M(N-54),53M(N-54)
   C. Types of Funds and Account Groups ..................... 54M(N-54),55M(N-54),56M(N-55),57M(N-55)
   D. Presentation of Financial Statements for Various
       Not-for-Profit and Governmental Organizations .... 58M(N-55)
   E. Various Types of Not-for-Profit and
       Governmental Organizations ................................. 59M(N-55),60M(N-55)
CONTRIBUTORS TO THIS UNIFORM CPA EXAMINATION

The Board of Examiners expresses its gratitude to the following contributors of questions appearing in the November 1991 examination.

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FUTURE CPA EXAMINATION DATES

1992 — May 6, 7, 8
   November 4, 5, 6
1993 — May 5, 6, 7
   November 3, 4, 5
1994 — May 4, 5
   November 2, 3
1995 — May 3, 4
   November 1, 2
1996 — May 8, 9
   November 6, 7
1997 — May 7, 8
   November 5, 6
1998 — May 6, 7
   November 4, 5
1999 — May 5, 6
   November 3, 4
2000 — May 3, 4
   November 1, 2

Beginning with the May 1994 Examination, the Examination testing time is scheduled to be shortened to two days.
CONTENT SPECIFICATION OUTLINES
Content Specification Outlines

The original content specification outlines were adopted by the Board of Examiners in 1981, effective for the November 1983 examination. In 1984 the Board of Examiners modified the original content specification outlines in order to incorporate the information obtained from an AICPA practice analysis study.

The practice analysis study documented the major work segments performed by certified public accountants in the practice of public accountancy and identified the knowledge, skills, and abilities necessary to perform those work segments. These content specification outlines, effective for the May 1989 Uniform CPA Examination, are based upon the results of the practice analysis study.

Meaning and Use of Content Specification Outlines

The content specification outlines are divided into three levels—areas, groups, and topics, with the following outline notations:

- Areas by Roman numerals (I. Area)
- Groups by capital letters (A. Group)
- Topics by Arabic numbers (1. Topic)

The content specification outlines list the areas, groups, and topics to be tested, and also indicate the approximate percentage of the total test score devoted to each area. Some of the uses of the outlines will be —

- To assure consistent subject-matter coverage from one examination to the next.
- To assist candidates in preparing for the examination by indicating subjects which may be covered by the examination.
- To provide guidance to those who are responsible for preparing the examination in order to assure a balanced examination.
- To alert accounting educators about the subject matter considered necessary to prepare for the examination.

The relative weight given to each area is indicated by its approximate percentage allocation. The examination will sample from the groups and topics listed within each area in order to meet the approximate percentage allocation. Generally, the group title should be sufficient to indicate the subject matter to be covered. However, in certain instances, topics have been explicitly listed in order to clarify or limit the subject matter covered within a group.

No weight allocation is given for groups or topics. For example, if there are several groups within an area or several topics within a group, no inference should be drawn about the relative importance or weight to be given to these groups or topics on an examination.

Clear-cut distinctions about subject matter do not always exist. Thus, there may be overlapping of subjects in the four sections of the examination. For example, Auditing questions often require a knowledge of accounting theory and practice, as well as of auditing procedures. Also, Business Law questions may be set in an accounting or auditing environment, and answers may involve integration with accounting and auditing knowledge.

The content specification outlines are considered to be complete in respect to the subjects to be tested on an examination, including recent professional developments as they affect these subjects. Candidates should answer examination questions, developed from these outlines, in terms of the most recent developments, pronouncements, and standards in the accounting profession. When new subject matter is identified, the outlines will be amended to include it and this will be communicated to the profession.

CSO-1
Accounting Practice Section

The Accounting Practice section tests the candidates' ability to apply current conceptual accounting knowledge. The section includes the following: financial accounting concepts relating to financial reports, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; not-for-profit and governmental accounting; and federal taxation.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, Governmental Accounting Standards Board, Internal Revenue Code, Federal Tax Regulations, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting.

Accounting Practice—Content Specification Outline

I. Presentation of Financial Statements or Worksheets (15 percent)
   A. Balance Sheet
   B. Income Statement
   C. Statement of Cash Flows
   D. Statement of Owners' Equity
   E. Consolidated Financial Statements or Worksheets

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (10 percent)
   A. Cash, Marketable Securities, and Investments
      1. Cash
      2. Marketable Equity Securities
      3. Other Securities
      4. Investment in Bonds
      5. Investment in Stocks
      6. Sinking and Other Funds
   B. Receivables and Accruals
      1. Accounts and Notes Receivable
      2. Affiliated Company Receivables
      3. Discounting of Notes
      4. Installment Accounts
      5. Interest and Other Accrued Income
      6. Allowance for Uncollectible Accounts
   C. Inventories
      1. Acquisition Costs
      2. Costing Methods
      3. Valuation Methods
   D. Property, Plant, and Equipment Owned or Leased
      1. Acquisition Costs
      2. Capital Versus Revenue Expenditures
      3. Depreciation, Amortization, and Depletion
      4. Leasehold Improvements
      5. Obsolescence and Write-downs
      6. Disposition
   E. Intangibles and Other Assets
      1. Goodwill
      2. Patents
III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)

A. Payables and Accruals
   1. Accounts Payable
   2. Notes Payable
   3. Accrued Employees' Costs
   4. Interest and Other Accrued Expenses
   5. Unfunded Accrued Pension Cost
   6. Taxes Payable
   7. Deposits and Escrows

B. Deferred Revenues
   1. Unperformed Service Contracts
   2. Subscriptions or Tickets Outstanding
   3. Installment Sales
   4. Sale and Leaseback

C. Deferred Income Tax Liabilities
   1. Equity Method of Accounting for Investments
   2. Depreciation of Plant Assets
   3. Long-Term Construction Contracts
   4. Other Temporary Differences

D. Capitalized Lease Liability
   1. Measurement at Present Value
   2. Amortization

E. Bonds Payable
   1. Issue of Bonds
   2. Issue Costs
   3. Amortization of Discount or Premium
   4. Types of Bonds
   5. Conversion of Bonds
   6. Detachable Stock Warrants
   7. Retirement of Bonds

F. Contingent Liabilities and Commitments

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)

A. Preferred and Common Stock
   1. Issued
   2. Outstanding
   3. Retirement of Stock
   4. Book Value Per Share
   5. Classification

B. Additional Paid-in Capital

CSO-3
C. Retained Earnings and Dividends
   1. Prior Period Adjustments
   2. Net Income
   3. Cash Dividends
   4. Property Dividends
   5. Liquidating Dividends
   6. Stock Dividends and Splits
   7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts
   1. Cost Method
   2. Par Value Method
   3. Restrictions on Acquisition of Treasury Stock
   4. Other Contra Accounts

E. Stock Options, Warrants, and Rights
F. Reorganization and Change In Entity
   1. Incorporation of an Unincorporated Enterprise
   2. Business Combinations
   3. Bankruptcy

G. Partnerships
   1. Formation
   2. Admission, Retirement, and Dissolution
   3. Profit and Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (15 percent)

A. Revenues and Gains
   1. Cash Versus Accrual Basis
   2. At Time of Sale
   3. At Completion of Production
   4. During Production (percentage of completion)
   5. Installment Method or Cost Recovery
   6. Equity in Earnings of Investee
   7. Interest
   8. Dividends
   9. Royalties
   10. Rent
   11. Disposal of Assets and Liquidation of Liabilities
   12. Foreign Exchange
   13. Unusual Gains

B. Expenses and Losses
   1. Cost of Sales
   2. General and Administrative
   3. Selling
   4. Financial (interest)
   5. Depreciation, Amortization, and Depletion
   6. Research and Development
   7. Foreign Exchange
   8. Uncollectible Accounts
   9. Royalties
   10. Rent
   11. Compensation
   12. Disposal of Assets and Liquidation of Liabilities
   13. Unusual Losses
C. Provision for Income Tax
   1. Current
   2. Deferred
D. Recurring Versus Nonrecurring Transactions and Events
   1. Discontinued Operations
   2. Extraordinary Items
E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics (5 percent)
A. Disclosures in Notes to the Financial Statements
B. Accounting Policies
C. Nonmonetary Transactions
D. Interim Financial Statements
E. Historical Cost, Constant Dollar Accounting, and Current Cost
F. Gain Contingencies
G. Segments and Lines of Business
H. Employee Benefits
I. Analysis of Financial Statements
J. Development Stage Enterprises
K. Personal Financial Statements
L. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control (10 percent)
A. Nature of Cost Elements
   1. Direct Materials
   2. Direct Labor
   3. Overhead
B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis
H. Capital Budgeting Techniques
   1. Net Present Value
   2. Internal Rate of Return
   3. Payback Period
   4. Accounting Rate of Return
I. Performance Analysis
   1. Return on Investment
   2. Residual Income
   3. Controllable Revenue and Costs
J. Other
   1. Regression and Correlation Analysis
   2. Economic Order Quantity
   3. Probability Analysis
   4. Variance Analysis
   5. Differential Cost Analysis
   6. Product Pricing
VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Fund Accounting
   1. Fund Balance
   2. Estimated Revenues
   3. Appropriations
   4. Encumbrances
   5. Fund Balance Reserved for Encumbrances
   6. Revenues
   7. Expenditures

B. Types of Funds and Account Groups
   1. General Fund
   2. Special Revenue Funds
   3. Debt Service Funds
   4. Capital Projects Funds
   5. Enterprise Funds
   6. Internal Service Funds
   7. Trust and Agency Funds
   8. General Fixed Assets Account Group
   9. General Long-Term Debt Account Group
   10. Endowment and Quasi-Endowment Funds
   11. Restricted and Unrestricted Funds
   12. Property Funds

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

D. Various Types of Not-for-Profit and Governmental Organizations
   1. Local and State Governments
   2. Educational Institutions
   3. Hospitals
   4. Charitable, Religious, and Other Organizations

IX. Federal Taxation—Individuals, Estates, and Trusts (10 percent)

A. Inclusions for Gross Income and Adjusted Gross Income
   1. Reporting Basis of Taxpayer—Cash, Accrual, or Modified
   2. Compensation for Services
   3. Business Income
   4. Interest
   5. Rent and Royalties
   6. Dividends
   7. Alimony
   8. Capital Gains and Losses
   9. Miscellaneous Income

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

C. Gain or Loss on Property Transactions
   1. Character
   2. Recognition
   3. Basis and Holding Period

D. Deductions from Adjusted Gross Income
E. Filing Status and Exemptions
F. Tax Computations and Credits
G. Statute of Limitations
Content Specification Outlines

1. Claims for Refund
2. Assessments

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations (10 percent)

Corporations

A. Determination of Taxable Income or Loss
   1. Determination of Gross Income, Including Capital Gains and Losses
   2. Deductions from Gross Income
   3. Reconciliation of Taxable Income and Book Income
   4. Reconciliation of Opening and Closing Retained Earnings
   5. Consolidations

B. Tax Computations and Credits
C. S Corporations
D. Personal Holding Companies
E. Accumulated Earnings Tax
F. Distributions
G. Tax-Free Incorporation
H. Reorganizations
I. Liquidations and Dissolutions

Partnerships

J. Formation of Partnership
   1. Contribution of Capital
   2. Contribution of Services

K. Basis of Partner's Interest
   1. Acquired Through Contribution
   2. Interest Acquired From Another Partner
   3. Holding Period of Partner's Interest
   4. Adjustments to Basis of Partner's Interest

L. Determination of Partner's Taxable Income and Partner's Elections
M. Accounting Periods of Partnership and Partners
N. Partner Dealing With Own Partnership
   1. Sales and Exchanges
   2. Guaranteed Payments

O. Treatment of Liabilities
P. Distribution of Partnership Assets
   1. Current Distributions
   2. Distributions in Complete Liquidation
   3. Basis of Distributed Property

Q. Termination of Partnership
   1. Change in Membership
   2. Merger or Split-up of Partnership
   3. Sale or Exchange of Partnership Interest
   4. Payments to a Retiring Partner
   5. Payments to a Deceased Partner's Successor

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, Governmental Accounting Standards Board, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting. Answers should be in accord with current accounting theory and not necessarily with accounting methods and practices promulgated by governmental agencies, such as the Internal Revenue Service and the Securities and Exchange Commission (unless these methods and practices are specifically required or are vital to a complete discussion of the issues involved).

Accounting Theory—Content Specification Outline

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards (15 percent)
   A. Authority of Pronouncements (substantial authoritative support—GAAP)
   B. Conceptual Framework
   C. Basic Concepts and Accounting Principles
   D. Nature and Purpose of Basic Financial Statements
   E. Consolidated Financial Statements
   F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (15 percent)
   A. Cash, Marketable Securities, and Investments
      1. Cash
      2. Marketable Equity Securities
      3. Other Securities
      4. Investment in Bonds
      5. Investment in Stocks
      6. Sinking and Other Funds
   B. Receivables and Accruals
      1. Accounts and Notes Receivable
      2. Affiliated Company Receivables
      3. Discounting of Notes
      4. Installment Accounts
      5. Interest and Other Accrued Income
      6. Allowance for Uncollectible Accounts
   C. Inventories
      1. Acquisition Costs
      2. Costing Methods
      3. Valuation Methods

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Content Specification Outlines

D. Property, Plant, and Equipment Owned or Leased
   1. Acquisition Costs
   2. Capital Versus Revenue Expenditures
   3. Depreciation, Amortization, and Depletion
   4. Leasehold Improvements
   5. Obsolescence and Write-downs
   6. Disposition

E. Intangibles and Other Assets
   1. Goodwill
   2. Patents
   3. Other Intangibles
   4. Prepaid Expenses
   5. Deferred Income Tax Assets
   6. Prepaid Pension Cost

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)

A. Payables and Accruals
   1. Accounts Payable
   2. Notes Payable
   3. Accrued Employees' Costs
   4. Interest and Other Accrued Expenses
   5. Unfunded Accrued Pension Cost
   6. Taxes Payable
   7. Deposits and Escrows

B. Deferred Revenues
   1. Unperformed Service Contracts
   2. Subscriptions or Tickets Outstanding
   3. Installment Sales
   4. Sale and Leaseback

C. Deferred Income Tax Liabilities
   1. Equity Method of Accounting for Investments
   2. Depreciation of Plant Assets
   3. Long-Term Construction Contracts
   4. Other Temporary Differences

D. Capitalized Lease Liability
   1. Measurement at Present Value
   2. Amortization

E. Bonds Payable
   1. Issue of Bonds
   2. Issue Costs
   3. Amortization of Discount or Premium
   4. Types of Bonds
   5. Conversion of Bonds
   6. Detachable Stock Warrants
   7. Retirement of Bonds

F. Contingent Liabilities and Commitments

CSO-9
IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)

A. Preferred and Common Stock
   1. Issued
   2. Outstanding
   3. Retirement of Stock
   4. Book Value Per Share
   5. Classification

B. Additional Paid-in Capital

C. Retained Earnings and Dividends
   1. Prior Period Adjustments
   2. Net Income
   3. Cash Dividends
   4. Property Dividends
   5. Liquidating Dividends
   6. Stock Dividends and Splits
   7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts
   1. Cost Method
   2. Par Value Method
   3. Restrictions on Acquisition of Treasury Stock
   4. Other Contra Accounts

E. Stock Options, Warrants, and Rights

F. Reorganization and Change in Entity
   1. Incorporation of an Unincorporated Enterprise
   2. Business Combinations
   3. Bankruptcy

G. Partnerships
   1. Formation
   2. Admission, Retirement, and Dissolution
   3. Profit or Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (20 percent)

A. Revenues and Gains
   1. Cash Versus Accrual Basis
   2. At Time of Sale
   3. At Completion of Production
   4. During Production (percentage of completion)
   5. Installment Method or Cost Recovery
   6. Equity in Earnings of Investee
   7. Interest
   8. Dividends
   9. Royalties
   10. Rent
   11. Disposal of Assets and Liquidation of Liabilities
   12. Foreign Exchange
   13. Unusual Gains

B. Expenses and Losses
   1. Cost of Sales
   2. General and Administrative

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3. Selling
4. Financial (interest)
5. Depreciation, Amortization, and Depletion
6. Research and Development
7. Foreign Exchange
8. Uncollectible Accounts
9. Royalties
10. Rent
11. Compensation
12. Disposal of Assets and Liquidation of Liabilities
13. Unusual Losses

C. Provision for Income Tax
   1. Current
   2. Deferred

D. Recurring Versus Nonrecurring Transactions and Events
   1. Discontinued Operations
   2. Extraordinary Items

E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics (15 percent)
A. Statement of Cash Flows
B. Accounting Policies
C. Accounting Changes
D. Nonmonetary Transactions
E. Business Combinations
F. Interim Financial Statements
G. Gain Contingencies
H. Segments and Lines of Business
I. Employee Benefits
J. Analysis of Financial Statements
K. Development Stage Enterprises
L. Personal Financial Statements
M. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control (10 percent)
A. Nature of Cost Elements
   1. Direct Materials
   2. Direct Labor
   3. Overhead

B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis
H. Capital Budgeting Techniques
   1. Net Present Value
   2. Internal Rate of Return
   3. Payback Period
   4. Accounting Rate of Return
Content Specification Outlines

I. Performance Analysis
   1. Return on Investment
   2. Residual Income
   3. Controllable Revenue and Costs

J. Other
   1. Regression and Correlation Analysis
   2. Economic Order Quantity
   3. Probability Analysis
   4. Variance Analysis
   5. Differential Cost Analysis
   6. Product Pricing

VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Conceptual Framework
B. Fund Accounting
   1. Fund Balance
   2. Estimated Revenues
   3. Appropriations
   4. Encumbrances
   5. Fund Balance Reserved for Encumbrances
   6. Revenues
   7. Expenditures

C. Types of Funds and Account Groups
   1. General Fund
   2. Special Revenue Funds
   3. Debt Service Funds
   4. Capital Projects Funds
   5. Enterprise Funds
   6. Internal Service Funds
   7. Trust and Agency Funds
   8. General Fixed Assets Account Group
   9. General Long-Term Debt Account Group
   10. Endowment and Quasi-Endowment Funds
   11. Restricted and Unrestricted Funds
   12. Property Funds

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
E. Various Types of Not-for-Profit and Governmental Organizations
   1. Local and State Governments
   2. Educational Institutions
   3. Hospitals
   4. Charitable, Religious, and Other Organizations

Auditing Section

The Auditing section tests the candidates' knowledge of generally accepted auditing standards and procedures. The section includes professional responsibilities, internal control, evidence and procedures, and reporting.

In preparing for this section, candidates should study publications such as the following:

- AICPA Code of Professional Conduct
- Statements on Auditing Standards
- U.S. General Accounting Office Government Auditing Standards

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Content Specification Outlines

- Statements on Standards for Accounting and Review Services
- Statements on Quality Control Standards
- Statements on Management Advisory Services
- Statements on Responsibilities in Tax Practice
- Statements on Standards for Attestation Engagements
- Statement on Standards for Accountants' Services on Prospective Financial Statements
- AICPA Audit and Accounting Guides
- Auditing textbooks

Auditing—Content Specification Outline

I. Professional Responsibilities (15 percent)
   A. General Standards and Code of Professional Conduct
      1. Proficiency, Independence, and Due Care
      2. Code of Professional Conduct
   B. Control of the Audit
      1. Planning and Supervision
      2. Audit Risk and Materiality
      3. Analytical Procedures
      4. Quality Control
   C. Other Responsibilities
      1. Detecting and Reporting Errors and Irregularities
      2. Illegal Acts by Clients
      3. Responsibilities in Review and Compilation
      4. Responsibilities in Attestation Engagements
      5. Responsibilities in Management Advisory Services
      6. Responsibilities in Tax Practice

II. Internal Control (30 percent)
   A. Definitions and Basic Concepts
   B. Consideration of the Internal Control Structure
   C. Cycles
      1. Sales, Receivables, and Cash Receipts
      2. Purchases, Payables, and Cash Disbursements
      3. Inventories and Production
      4. Personnel and Payroll
      5. Financing and Investing
   D. Other Considerations
      1. Communication of Internal Control Structure Related Matters
      2. Reports on Internal Control
      3. Sampling
      4. Flowcharting

III. Evidence and Procedures (30 percent)
   A. Audit Evidence
      2. Evidential Matter for Financial Statement Assertions
      3. Analytical Procedures
      4. Client Representations

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Content Specification Outlines

5. Using the Work of a Specialist
6. Inquiry of a Client's Lawyer

B. Specific Audit Objectives and Procedures

1. Tests of Details of Transactions and Balances
2. Documentation

C. Other Specific Audit Topics

1. Use of the Computer in Performing the Audit
2. Use of Statistical Sampling in Performing the Audit
3. Related Party Transactions
4. Subsequent Events
5. Compliance Auditing
6. Omitted Procedures Discovered After the Report Date

D. Review andCompilation Procedures

1. Understanding of Accounting Principles and Practices of the Industry
2. Inquiry and Analytical Procedures
3. Unusual Matters
4. Other Procedures

IV. Reporting (25 percent)

A. Reporting Standards and Types of Reports

1. Unqualified
2. Explanatory Language Added to the Standard Report
3. Qualified
4. Adverse
5. Disclaimer
6. Consistency
7. Going Concern
8. Reporting Responsibilities
9. Comparative
10. Scope of Examination
11. Generally Accepted Accounting Principles
12. Disclosure
13. Review and Compilation
14. Review of Interim Financial Information
15. Special Reports
16. Negative Assurance
17. Prospective Financial Statements
18. Compliance With Laws and Regulations

B. Other Reporting Considerations

1. Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
2. Dating of the Auditor's Report
3. Part of Examination Made by Other Independent Auditors
4. Letters for Underwriters
5. Filing Under Federal Securities Statutes
6. Other Information in Documents Containing Audited Financial Statements
7. Required Supplementary Information
8. Information Accompanying the Basic Financial Statements
9. Communication With Audit Committees

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Content Specification Outlines

Business Law Section

The Business Law section tests the candidates' knowledge of the legal implications of business transactions, particularly as they relate to accounting and auditing. The section includes the CPA and the law, business organizations, contracts, debtor-creditor relationships, government regulation of business, Uniform Commercial Code, and property. The subjects on the examination normally are covered in standard textbooks on business law, auditing, taxation, and accounting. Candidates are expected to recognize the existence of legal implications and applicable basic legal principles, and they are usually asked to indicate the probable result of the application of such basic principles.

The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test competence to practice law or expertise in legal matters, but to determine that the candidates' knowledge is sufficient (1) to recognize relevant legal issues, (2) to recognize the legal implications of business situations, (3) to apply the underlying principles of law to accounting and auditing situations, and (4) to seek legal counsel or recommend that it be sought.

This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test knowledge of the majority rules. Federal tax elements may be covered where appropriate in the overall context of a question.

Business Law—Content Specification Outline

I. The CPA and the Law (10 percent)
   A. Common Law Liability to Clients and Third Persons
   B. Federal Statutory Liability
      1. Securities Acts
      2. Internal Revenue Code
   C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations (20 percent)
   A. Agency
      1. Formation and Termination
      2. Liabilities of Principal
      3. Disclosed and Undisclosed Principals
      4. Agent's Authority and Liability
   B. Partnerships and Joint Ventures
      1. Formation and Existence
      2. Liabilities and Authority of Partners and Joint Owners
      3. Allocation of Profit or Loss
      4. Transfer of Interest
      5. Termination, Winding Up, and Dissolution
   C. Corporations
      1. Formation, Purposes, and Powers
      2. Stockholders, Directors, and Officers
      3. Financial Structure, Capital, and Dividends
      4. Merger, Consolidation, and Dissolution
   D. Estates and Trusts
      1. Formation and Purposes
      2. Allocation Between Principal and Income
      3. Fiduciary Responsibilities
      4. Distributions and Termination

CSO-15
III. Contracts (15 percent)

A. Offer and Acceptance
B. Consideration
C. Capacity, Legality, and Public Policy
D. Statute of Frauds
E. Statute of Limitations
F. Fraud, Duress, and Undue Influence
G. Mistake and Misrepresentation
H. Parol Evidence Rule
I. Third Party Rights
J. Assignments
K. Discharge, Breach, and Remedies

IV. Debtor-Creditor Relationships (10 percent)

A. Suretyship
   1. Liabilities and Defenses
   2. Release of Parties
   3. Remedies of Parties

B. Bankruptcy
   1. Voluntary and Involuntary Bankruptcy
   2. Effects of Bankruptcy on Debtor and Creditors
   3. Reorganizations

V. Government Regulation of Business (10 percent)

A. Regulation of Employment
   1. Federal Insurance Contributions Act
   2. Federal Unemployment Tax Act
   3. Worker’s Compensation Acts

B. Federal Securities Acts
   1. Securities Registration
   2. Reporting Requirements
   3. Exempt Securities and Transactions

VI. Uniform Commercial Code (25 percent)

A. Commercial Paper
   1. Types of Negotiable Instruments
   2. Requisites for Negotiability
   3. Transfer and Negotiation
   4. Holders and Holders in Due Course
   5. Liabilities, Defenses, and Rights
   6. Discharge

B. Documents of Title and Investment Securities
   1. Warehouse Receipts
   2. Bills of Lading
   3. Issuance, Transfer, and Registration of Securities

C. Sales
   1. Contracts Covering Goods
   2. Warranties
Content Specification Outlines

3. Product Liability
4. Risk of Loss
5. Performance and Obligations
6. Remedies and Defenses

D. Secured Transactions
   1. Attachment of Security Interests
   2. Perfection of Security Interests
   3. Priorities
   4. Rights of Debtors, Creditors, and Third Parties

VII. Property (10 percent)

A. Real and Personal Property
   1. Distinctions Between Realty and Personalty
   2. Types of Ownership
   3. Lessor-Lessee
   4. Deeds, Recording, Title Defects, and Title Insurance

B. Mortgages
   1. Characteristics
   2. Recording Requirements
   3. Priorities
   4. Foreclosure

C. Fire and Casualty Insurance
   1. Coinsurance
   2. Multiple Insurance Coverage
   3. Insurable Interest
Accounting Practice

Accounting Theory

Auditing

Business Law

November 1991 Uniform CPA Examination

Content Specification Outlines