

3-1931

## Institute Examination in Law

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### Recommended Citation

Gordon, Spencer (1931) "Institute Examination in Law," *Journal of Accountancy*. Vol. 51 : Iss. 3 , Article 6.  
Available at: <https://egrove.olemiss.edu/jofa/vol51/iss3/6>

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# Institute Examination in Law

BY SPENCER GORDON

[The following answers to the questions set by the board of examiners of the American Institute of Accountants at the examinations of November, 1930, have been prepared at the request of THE JOURNAL OF ACCOUNTANCY. These answers have not been reviewed by the board of examiners and are in no way official. They represent merely the personal opinions of the author.—*Editor*, THE JOURNAL OF ACCOUNTANCY.]

## EXAMINATION IN COMMERCIAL LAW

November 14, 1930, 9 A. M. to 12:30 P. M.

### GROUP I

*Answer all questions in this group, giving reasons for your answers.*

No. 1:

In the course of an audit you find that your client has recently purchased improved real estate. He shows you an unexpired fire-insurance policy accurately describing the buildings but payable to the former owner and not assigned or transferred to your client. He says he is fully protected because the buildings are insured and the policy "runs with the property insured." Is his statement correct?

*Answer:*

A fire-insurance policy is held to be a personal contract with the assured, insuring whatever interest he may have in the premises. Such a policy does not "run with the property insured," and sale of the property will not operate as an assignment.

No. 2:

On July 7, 1930, a stranger called at the office of Dunham, a public accountant, exhibited the card of a well-known stationery house and obtained an order for analysis paper. On the next day the analysis paper was received by Dunham, together with an invoice payable in 30 days. On July 15, 1930, the stranger called and asked Dunham whether he would pay then for the paper. Dunham paid in cash and the stranger receipted the bill. It developed that the stranger was a solicitor who received a commission on any order accepted and filled, and that he had disappeared without accounting for the collection from Dunham. Can the stationery house collect from Dunham for this paper?

*Answer:*

The stationery house can collect from Dunham. In the absence of actual authority, an agent without possession of goods sold has no power to receive payment. A buyer paying a salesman in such circumstances does so at his own risk.

No. 3:

Blair, a public accountant, rendered professional services to Jenkins without agreement in advance as to the amount of the fee. Upon completion of the work, Jenkins gave Blair his negotiable promissory note for \$2,000 payable 30 days after date, in payment for Blair's services. Two weeks thereafter Jenkins had Blair's work appraised by three disinterested experts, all of whom

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agreed that the fair value of it was \$500. In an action by Blair on this note, can Jenkins successfully defend on the ground of inadequacy of consideration?

*Answer:*

Inadequacy of consideration is not a defense to a note given in payment for services, regardless of their true value, unless the note was procured by fraud. Courts will not look into the sufficiency of the consideration for which a note was given where that consideration is of indeterminate value.

No. 4:

A corporation had a deficit of \$40,000 at January 1, 1929. During that year it earned a net income from all sources amounting to \$35,000. In January, 1930, the board of directors declared a dividend of \$10,000 out of the 1929 profits. Would this dividend have been legal in your state?

*Answer:*

Dividends may be paid only from surplus. This is usually defined as the excess of assets over all liabilities, including capital stock as a liability. In such case a previous deficit must thus be made up from current profits before a fund is created from which dividends may be lawfully declared.

No. 5:

Brown, Coates and Danforth were partners sharing profits in proportions of one-fourth, one-third and five-twelfths, respectively. Their business failed and the firm was dissolved. At the time of dissolution no financial adjustments among partners were necessary but the firm's liabilities to creditors exceeded its assets by \$24,000. Without contributing any amount toward the payment of the liabilities, Coates moved to Europe, where he was not subject to legal process. Brown and Danforth are financially responsible. How much must each contribute?

*Answer:*

In the absence of specific agreement, partnership losses are apportioned as between the partners in the same proportion that profits are shared. Insolvency of any partner or removal without the jurisdiction does not change this rule; the entire loss is borne by the remaining partners in the same ratio as between them that they shared the profits. Brown and Danforth share the loss in the ratio of one-fourth to five-twelfths, or \$9,000 and \$15,000, respectively, and can recoup from each other to effect this result. As regards third party creditors, each is liable for the whole loss.

### GROUP II

*Answer any five of the questions in this group, but no more than five.*

No. 6:

Curtis, a public accountant, was engaged by Black to make an audit of Black's books, at specified per-diem rates. During the course of this audit, Curtis uncovered a defalcation whereby Black saved \$25,000. After the audit was concluded and Curtis had rendered his report, Black promised to pay Curtis an additional fee of \$5,000 for uncovering the defalcation. Can Curtis hold Black to this promise?

*Answer:*

A promise must be supported by consideration to be enforceable against the promisor. Services rendered in the past under a previous contract at agreed rates are not consideration for a subsequent promise, although the services were fairly worth more than the sum agreed to be paid. Curtis can not force Black to pay the additional \$5,000.

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No. 7:

Thompson gave a promissory note, endorsed by Sherwood, to Babcock. This was a demand note for \$5,000 with interest at 6 per cent. Later, without Sherwood's knowledge, Babcock made a valid agreement with Thompson reducing the interest rate to 5 per cent. Upon Thompson's failure to pay the note, Sherwood contended that he had been discharged from liability because Babcock had changed Thompson's agreement. Is his contention sound?

*Answer:*

The general rule is that any material change of a contract, binding on the principal, made without the consent of the surety thereon discharges the surety. The interest rate is a material provision of the contract, and where the suretyship is voluntary, the change discharges the surety even if non-prejudicial. The change, however, must be in the contract itself and not merely an independent agreement collateral thereto. While an actual alteration of the note would discharge the endorser, it has been held that an agreement binding on maker and payee to reduce the rate of interest is not an alteration of the contract, but a collateral agreement which will not discharge the endorser.

No. 8:

At 11:30 a. m. Shaw wired Brauer, "Subject prompt reply will engage you to make audit \$2,000 fee." Brauer received this wire at 12:16 p. m. At 12:28 p. m. Brauer wired Shaw accepting the offer. At 1 p. m. Shaw had not received Brauer's wire and Shaw wired Brauer revoking his offer. At 1:43 p. m. Shaw received Brauer's wire accepting the offer. Was there a contract?

*Answer:*

An offer sent by wire impliedly authorizes an acceptance by the same means. Such an acceptance, if made within the required time and before revocation, is effective from the moment it is given the telegraph company for transmission, and, other essentials being present, a contract results. An offer is not revoked until a revocation has been received by the offeree. Brauer's prompt acceptance of the offer, sent prior to his receipt of the revocation, completes the formation of a contract if other requirements are present.

It is essential to a contract that the nature and extent of the obligations assumed by each of the parties be certain, although it is not necessary that they be set forth in the written offer and acceptance if they are understood at the time by the parties. In the present case, if Brauer knows to what audit Shaw refers, its general nature and extent, whether from previous dealings or a knowledge of Shaw's business, then the minds of the parties have met and a contract results. If Brauer knows nothing of the audit referred to beyond what is contained in the telegram, then the incidents of the offer and acceptance are too uncertain to result in a contract.

No. 9:

Hughes was a bookkeeper for the Sutton mills, receiving his salary monthly under a contract providing that if he left without giving two weeks' notice he should receive nothing for wages accrued during the current month. On June 14, 1930, Hughes was arrested, convicted and sentenced to jail. The damage to the Sutton mills from want of notice was greater in amount than one-half of Hughes' salary for June. Can Hughes recover his salary for the period from June 1st to June 14th?

*Answer:*

Hughes can recover his salary from June 1st to 14th. A contract providing for a forfeiture of wages for leaving without notice is interpreted to mean a

voluntary leaving only, and the forfeiture will not be enforced against an employee who is arrested and imprisoned.

No. 10:

Bishop, a public accountant, desiring to retire from practice, sold all his assets including his goodwill to Palmer for a stated sum. As a part of the sale Bishop covenanted that he would not engage in the public practice of accounting anywhere for a period of ten years. Is this agreement by Bishop valid?

*Answer:*

An agreement not to engage in the public practice of a profession or trade, entered into in consideration of the sale of such business, is valid only if it constitutes a reasonable protection of the business sold. An agreement not to engage in the public practice of accounting, unlimited as to space, extends further than a reasonable protection for the business sold requires, and such agreement is invalid as being in restraint of trade.

No. 11:

C. A. Nimocks was a promoter engaged in effecting the organization of the Times Printing Company. On September 12, 1928, on behalf of the proposed corporation, he made a contract with McArthur for his services as comptroller for the period of one year beginning October 1, 1928. The Times Printing Company was incorporated October 16, 1928, and at that date McArthur commenced his duties as comptroller. No formal action with reference to his employment was taken by the board of directors or by any officer, but all the stockholders, directors and officers knew of the contract made by Nimocks. On December 1, 1928, McArthur was discharged without cause. Has he cause of action against the Times Printing Company?

*Answer:*

A contract for services, made prior to incorporation, in the name and on behalf of a proposed corporation, is held to be adopted by that corporation as of the date of incorporation if it accepts the services contracted for with full knowledge of the contract. McArthur has a cause of action against the printing company for damages for his wrongful discharge in breach of this contract.

No. 12:

Section 12 of the revenue act of 1928 provides that there shall be no surtax upon a net income of a specified amount; section 25 provides for certain credits against net income; section 22 (b) provides that certain items shall be excluded from gross income; section 23 allows certain deductions from gross income. Assume an individual's total income from all sources to be \$100,000. Using round amounts to illustrate one or more of the items covered by each of the last three sections listed above, show the computation of his net income subject to normal tax and of his net income subject to surtax (the computation of the tax is not required).

*Answer:*

An individual's total income from all sources is assumed to be \$100,000 composed of the following items:

(1) Salary .....	\$ 40,000
(2) Dividends from domestic corporations .....	20,000
(3) Interest on state obligations .....	15,000
(4) Gift (not made as consideration for service rendered).....	10,000
(5) Rent from building .....	10,000
(6) Profit from sale of stock .....	5,000

Total income..... \$100,000

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Under section 22 (b), revenue act of 1928, interest on obligations of a state and gifts not made as consideration for services rendered are excluded from gross income. Total income of \$100,000 is therefore reduced by \$25,000, resulting in gross income of \$75,000.

The above taxpayer is entitled to certain deductions under section 23, revenue act of 1928. Such deductions would be as follows:

(1) Interest paid on indebtedness to carry stocks on margin . . . . .	\$ 2,000
(2) Real estate taxes paid in the sum of . . . . .	3,000
(3) Loss by fire of building, not covered by insurance, resulting in loss sustained of . . . . .	10,000
(4) Bad debt . . . . .	5,000
	<hr/>
Total deductions . . . . .	\$20,000

The gross income of \$75,000 is decreased by deductions of \$20,000, resulting in a net income of \$55,000.

Under section 25, revenue act of 1928, certain credits are allowed against net income for normal tax purposes. Assuming that the taxpayer is a married man, living with his wife and assuming that he has one child, he would be entitled to personal exemption of \$3,500, plus \$400, or \$3,900. Furthermore, dividends from domestic corporations in the sum of \$20,000 are a credit against net income for normal tax purposes making a total credit of \$23,900.

The income subject to normal tax is therefore the sum of \$55,000 net income, minus \$23,900 credit, or \$31,100.

The aforesaid credits however are not allowed for surtax purposes. Surtaxes are not imposed on the first \$10,000 net income, so that the net income of \$55,000 is reduced by \$10,000 and the resulting \$45,000 is subject to surtax.