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American Institute of Accountants. Board of Examiners

American Institute of Accountants' Examinations

[Following is the text of the examinations in auditing, law and accounting presented by the board of examiners of the American Institute of Accountants, November 16 and 17, 1933.]

Examination in Auditing

November 16, 1933, 9 a. m. to 12:30 p. m.

Answer all the following questions:

No. 1 (10 points):

(a) What items in the balance-sheet of a manufacturing and trading concern would you normally classify as current assets and current liabilities?

(b) State upon what tests you would rely to determine whether items in part or in whole were properly classified under such headings.

No. 2 (10 points):

In auditing the A Corporation you find that during the year it has taken over the assets (except goodwill) and the liabilities of the B Corporation in exchange for an agreed amount of stock of the A Corporation at par. The said assets and liabilities have been merged with those of the A Corporation, and the latter's goodwill account has been increased to balance the balance-sheet after merger. You are satisfied that all values are sound.

(a) What is indicated as to the consideration paid by Corporation A?

(b) Should it be reflected in the goodwill account of A or not? Give your reasons.

(c) In what other manner might the transaction be treated on A's books?

(d) Supposing the conditions upon which your answer to (a) is based to be reversed, how would you treat the transaction?

No. 3 (5 points):

In the code of ethics of the American Institute of Accountants it is provided that no member shall advertise his professional attainments. Explain the principle underlying this rule.

No. 4 (15 points):

You are auditing the accounts of the Smith Corporation for the year 1931, and ascertain the following facts:

(1) The Smith Corporation owns a one-half interest in the Jones Corporation, which manufactures parts used by the Smith Corporation in its products.

(2) The Jones Corporation had been highly profitable up to December 31, 1928, and has accumulated five million dollars in earned surplus, but in 1931 it earned only $25,000.

(3) Up to December 31, 1930, the Jones Corporation had never paid any dividends to its stockholders, but in 1931 it declared and paid two million dollars out of its surplus.

(4) The Smith Corporation credited its dividend from the Jones Corporation to current earnings, and its profit-and-loss statement for the year 1931 shows the following composite item:

"Net earnings for the year to Dec. 31, 1931, after deducting discounts, allowances, cost of sales, depreciation, selling and administrative expenses, and after crediting discounts and miscellaneous income . . . . $500,000"

(a) Would you or would you not certify this statement? Give your reasons.

(b) If not, then give two modified statements, either of which you would be willing to certify.

No. 5 (10 points):

The Dimenslot Company maintains a branch office in a distant city where the only financial transactions authorized are the collection and banking of receipts from automatic vending machines, the payment of branch payrolls and expenses, and the remittance to the factory of funds in excess of branch requirements. Monthly reports of cash receipts and disbursements are sent to the factory.

As auditor you send to your representative in the branch city twelve monthly reports covering the year under audit with instructions to audit the branch records. In due course you receive a report stating that the monthly reports are in agreement with the books and that the balance in bank has been duly confirmed by the depository. The report also states that the deposits, as shown by the bank statements, exceeded the receipts, and the cheques issued by the branch exceeded the disbursements shown by the books. Such excesses consisted of items of which a list is enclosed without comments, showing in totals the following disbursements:

Bank loans, partly renewals, finally paid in full	$12,000.00
Cheques to employees	2,000.00
Accommodation purchases for employees	2,088.99

(a) What would these three items suggest to you?

(b) What should be the contra items with respect to each?

(c) What criticism would you make of your representative's report?

(d) What further steps, if any, would you take in the matter?

No. 6 (10 points):

On March 6, 1933, you start an emergency audit of the A. B. Company and you are required to render a certified balance-sheet as of that date. You find the cash on hand to consist mainly of cheques drawn on banks all over the country in payment of accounts receivable which have been duly credited by the bookkeeper. By proclamations of the president and governors of states all the banks involved have been closed, and you have learned from confidential sources that only sound banks will be permitted to reopen. Your client's own bank is regarded as perfectly sound. Given full power by your client to use your own judgment

(a) What instructions will you give the bookkeeper?

(b) How will you treat the items of cash and accounts receivable on the balance-sheet in giving an unqualified certificate? Give your reasons.

No. 7 (10 points):

You are auditing the books of a company incorporated in the United States and of its Canadian subsidiary company for the year 1931. You find that the accounts of the subsidiary have been consolidated with those of the parent company on the basis of par of Canadian exchange throughout the year, in spite of the fact that the Canadian dollar has been below par most of the year, and was at 83% of the U. S. dollar on December 31, 1931.

(a) Should any exchange gain or loss be recognized? If so, should it be reflected in the consolidated accounts?

(b) Upon what bases should the conversion of fixed assets (including the credits to the fixed-asset accounts for property retirements and the provision for depreciation) be made?

(c) Upon what basis would you convert the funded indebtedness, subject to what exception?

(d) Upon what basis would you convert an inventory of goods of the Canadian company purchased during 1930?

No. 8 (10 points):

(a) What is a "stock right," and how is it declared?

(b) Give the formula for ascertaining the theoretical value of a "right" as attaching to each old share, explaining the meaning of your symbols.

(c) Give an example in actual figures.

No. 9 (10 points):

(a) The Interstate Holding Company owns capital stock of three subsidiary companies, A, B, and C, in proportions (to the total outstanding stock of each) of 95%, 90% and 60%, respectively. In preparing statements of the holding company for the guidance of its directors in deciding upon the declaration or omission of dividends, what cognizance, if any, would you take of the following facts?

1. That the book value of A Company's stock is less than that at which it is carried by the holding company because of heavy losses incurred in the current year through inefficient management.

2. The book value of B Company's stock is substantially less than that at which it is carried by the holding company, as a direct result of the subsidiary's having declared and paid dividends during the current year in excess of profits.

3. That C Company's stock, which is carried on the holding company's books at an average cost in the open market of $84 a share, is quoted on the New York stock exchange at $10 at the balance-sheet date. Investigation shows that this shrinkage is directly attributable to two factors, (1) adverse conditions in the industry and (2) general financial conditions and other causes entirely unrelated to the business.

(b) State briefly what your treatment of the foregoing factors would be in preparing a balance-sheet for the holding company.

No. 10 (10 points):

The X Company, which owns 90% respectively of the stocks of the Y and Z Companies, submits consolidated statements showing, among other things:

Income of $9,000 dividend received from the Y Company, which actually earned $12,000 during the current year.

Net liability to minority stockholders of Z Company $9,000, which is explained to be the difference between the minority capital stock of $10,000 and a loss of $1,000 for the current year sustained by the Z Company.

If you find any error in either or both of the above items, state how it should be corrected.

Examination in Accounting Theory and Practice

PART I

NOVEMBER 16, 1933, 1:30 P. M. TO 6:30 P. M.

Answer problems 1, 2 and 3 and either problem 4 or problem 5.

No. 1 (30 points):

On the basis of the following information prepare:

1. A balance-sheet of all funds after closing the books at December 31, 1932.
2. A statement of the current surplus of the general fund for the year, showing the revenue, the expenditures and other items increasing or decreasing surplus during the year and the balance of surplus at the end of the year.
3. A statement of income and expense of the water department for the year.

The city of Dowell classifies its accounts under four different funds. The balances in the accounts of those funds on January 1, 1932, and on December 31st of the same year before closing were as follows:

General fund	January 1st	December 31st
Cash	$ 10,162	$ 21,215
1931 taxes receivable	15,676	12,429
Accounts receivable	2,325	3,545
Stores	9,641	9,533
Permanent property	3,154,695	3,154,695
1932 taxes receivable		60,838
Estimated revenue from taxes		225,000
Estimated revenue from miscellaneous sources		62,000
Appropriation expenditures for current purposes		234,398
Appropriation expenditures for capital additions		8,716
Appropriation expenditures for payment of bonds		25,000
Appropriation encumbrances (1932)		5,842
	$3,192,499	$3,823,211

	January 1st	December 31st
Accounts payable	$ 2,826	$ 5,626
Reserve for 1931 taxes	10,200	10,200
Reserve for orders and contracts	3,286	5,842
Reserve for stores	10,000	10,000
Current surplus	11,492	11,603
Bonds payable	250,000	225,000
Capital surplus	2,904,695	2,929,695
1932 tax anticipation notes payable		25,000
Reserve for 1932 taxes		24,766
Revenue from taxes		222,894
Revenue from miscellaneous sources		64,325
Appropriations		276,000
Estimated budget surplus		11,000
Sale of old equipment		1,260
	$3,192,499	$3,823,211

Water fund	January 1st	December 31st
Cash	$ 6,126	$ 717
Accounts receivable	7,645	5,573
Stores	13,826	12,635
Investments of replacement fund	21,700	24,500
Permanent property	212,604	214,204
Labor and material expense		109,638
Interest on bonds		3,000
Depreciation charge		10,600
Accounts of prior years written off		1,097
Expended for additions to plant		12,460
	$ 261,901	$ 394,424
Accounts payable	$ 4,324	$ 4,318
Customers deposits	1,500	1,600
Replacement fund reserve	21,700	24,500
Operating surplus	21,773	21,773
Bonds payable	60,000	40,000
Capital surplus	152,604	154,204
Services billed		146,867
Deposits lapsed		60
Interest on investments		1,102
	$ 261,901	$ 394,424

Assessment fund	January 1st	December 31st
Improvement No. 50		
Cash	$ 4,653	$ 1,844
Assessments receivable	46,829	33,414
Delinquent assessments receivable	4,826	2,010
Public benefit receivable	5,632	4,516
Interest on bonds		3,000
	$ 61,940	$ 44,784
Bonds payable	$ 60,000	$ 40,000
Surplus	1,940	1,940
Interest on assessments		2,844
	$ 61,940	$ 44,784

Improvement No. 51	January 1st	December 31st
Cash		$ 851
Assessments receivable		21,600
Public benefit receivable		2,400
		$ 24,851
Bonds payable		$ 24,000
Surplus		390
Interest on assessments		461
		$ 24,851

Trust funds	January 1st	December 31st
Cash	$ 3,216	$ 31
Investments	94,425	99,425
Premium on investments		800
Accrued interest purchased		260
Cemetery maintenance		849
Cemetery expense		2,976
Policemen's pensions paid		3,200
Firemen's pensions paid		2,400
	$ 97,641	$ 109,941
Cemetery endowment fund reserve	$ 60,000	$ 60,000
Policemen's pension fund reserve	18,691	18,691
Firemen's pension fund reserve	16,824	16,824
Cemetery maintenance fund reserve	2,126	2,126
Profit on sale of investments		600
Undistributed income		4,800
Policemen's pension fund contributions		4,160
Firemen's pension fund contributions		2,740
	$ 97,641	$ 109,941

It is the practice of the city to close out the unencumbered balance of appropriations of the general fund at the end of each year. Depreciation on the general property of the city is not entered and accrued interest on investments or on outstanding bonds is disregarded. Income and profit on trust fund investments are distributed 62% to cemetery funds, 20% to policemen's pension fund, 18% to firemen's pension fund.

The cemetery maintenance fund consists of the income from the cemetery endowment fund and is used for cemetery expense. Excess of receipts over disbursements of pension funds are closed to the reserve accounts of the respective funds at the end of each year.

Attention is directed to the following facts and conditions at the close of the year 1932:

(1) 1931 taxes in excess of the reserve against them are to be written off.

(2) Because of the increased uncertainty of 1932 tax collections the reserve on them is to be increased by fifty per cent.

(3) Invoices on all orders and contracts outstanding at beginning of year have been paid with a saving of $111, which has been credited to current surplus.

(4) The old property sold during the year was carried in the accounts at a value of $6,000.

(5) Permanent property valued at $1,820, becoming useless, was discarded during the year.

(6) Replacements of water-department equipment costing $6,200 were made from the replacement fund during the year at a cost of $7,800.

No. 2 (30 points):

On the basis of the following data prepare:

1. The surplus section of the balance-sheet that you will submit.
2. Subsidiary schedules showing the computation of the items in this surplus section.
3. The reconcilement between the $5,670,000 shown in your analysis and the amount that will be shown on your balance-sheet.

Your summarized analysis of the surplus of the Electrical Appliance Manufacturing Co. from January 1, 1908, the date of incorporation, to December 31, 1932, the date of your audit, is as follows:

Credits

Date	Description	Amount
Jan. 1, 1908 to Dec. 31, 1932	Net income carried to surplus	$10,000,000
Dec. 31, 1915	By debit to goodwill—as authorized by board of directors	510,000
Jan. 1, 1920	Patents granted to Josiah Thompson on January 1, 1920; donated to the company by him as of January 1, 1920; valued by the board of directors at $340,000 as of January 1, 1920	340,000
Dec. 31, 1920	Premium on common capital stock sold	300,000
Jan. 1, 1923	Profit on sale of plant to subsidiary Company A	100,000
Jan. 1, 1923	Profit on sale of plant to subsidiary Company B	200,000
Jan. 1, 1926	Appreciation by appraisal:	
	Land	200,000
	Building	500,000
	Machinery and equipment	300,000
Jan. 1, 1926	Donation to company of 5,000 shares (being the entire amount) of its preferred capital stock then outstanding	500,000
Jan. 1, 1928	Profit on sale of entire capital stock of subsidiary Company A to outside interests	175,000
Dec. 31, 1931	Discount on common capital stock reacquired and retired	200,000
Dec. 31, 1932	Discount on $500,000 face amount of the company's first-mortgage bonds reacquired and retired	100,000

Dec. 31, 1932	Reduction of capital stock from par value of $100 per share to the same number of shares with par value of $50 per share, as authorized by the stockholders at special meeting held December 21, 1932	$2,000,000
Jan. 1, 1923 to Dec. 31, 1927	Undistributed earnings (i. e., net increase in earned surplus) of subsidiary Company A, taken up by debit to investment in subsidiary Company A	100,000
Jan. 1, 1923 to Dec. 31, 1932	Undistributed earnings (i. e., net increase in earned surplus) of subsidiary Company B, taken up by debit to investment in subsidiary Company B	700,000
	Total credits	$16,225,000

Debits

Date	Description	Amount
Jan. 1, 1908 to Dec. 31, 1932	Cash dividends paid on common stock	$ 8,000,000
Jan. 1, 1915 to Dec. 31, 1925	Cash dividends paid on preferred stock	330,000
Jan. 1, 1925 to Dec. 31, 1932	Dividends on common stock paid in common stock out of earned surplus	1,000,000
Jan. 1, 1915	Discount on sale of 5,000 shares of 6% preferred stock, par value $100 per share, at 85	75,000
Jan. 1, 1923	Discount of 10% on $2,000,000 of 6% First Mortgage 20 year gold bonds dated January 1, 1923	200,000
Dec. 31, 1932	Provide reserve for excess of cost over market value of marketable securities owned at December 31, 1932	200,000
Dec. 31, 1932	Provide reserve for obsolescence of inventory at December 31, 1932	400,000
Dec. 31, 1932	Write off the book value of the Market Street plant abandoned as of December 31, 1932	350,000
	Total debits	$10,555,000
	Balance—net credit	$ 5,670,000

You also have in your papers the following information:

The goodwill account of $510,000 was transferred to the patent account as of January 1, 1923, by order of the board of directors.

The company provided for depreciation at the rate of 3% per annum on buildings and 10% per annum on machinery and equipment, computed on the book value. The company owns or owned the entire capital stock of two subsidiary companies, A and B.

Dividends of $400,000 were received from subsidiary Company B and credited to investment in subsidiary Company B.

A reserve for amortization of patents was provided by annual charges of 1/17th of the charges to the patent account.

The net book value of the Market Street plant at December 31, 1932, was $350,000, which was found to consist of:

	Cost	Appreciation Jan. 1, 1926	Reserve for depreciation
Land	$ 20,000	$ 50,000	
Buildings	200,000	100,000	$ 70,000
Machinery and equipment	300,000	50,000	300,000
Total	$520,000	$200,000	$370,000

No. 3 (20 points):

On January 1st the inventory at market values of working cattle and live stock on a plantation in the West Indies was as follows:

	Number	Unit Price	Amount
Work animals (bulls and oxen)	1,588	$ 52	$ 82,576
Horses	16	120	1,920
Cows	274	30	8,220
Heifers	137	20	2,740
Young bulls	220	30	6,600
One year heifers (under two years)	82	15	1,230
One year bulls (under two years)	127	20	2,540
Bull calves (under one year)	137	10	1,370
Heifer calves (under one year)	114	10	1,140
Breeding bulls	6	150	900
Together	2,701		$109,236

During the year, the following changes took place:

Births—
145 bull calves
130 heifers

Deaths—
261 work animals
5 cows
4 heifers
3 bull calves

Found—
8 work animals
12 bull calves (new)
5 heifer calves (new)

Purchased (all on hand at the end of the year)—
120 work animals at $45
41 young bulls at $30

Sold—
63 work animals
4 cows
2 horses

Lost—
7 work animals

During the year 73 heifers were reclassified as cows and 175 young bulls as work animals. All of them were on hand at the end of the year.

The market values remained the same throughout the year except that work animals were worth $43 a head at the end of the year.

Prepare:

1. A columnar statement showing opening and closing inventories with number, unit price and value, together with all numerical changes during the year, making such further adjustments as may be necessary.

2. A statement showing the amount of the opening inventory, the amounts of increases through appreciation, purchase, birth, etc. and of decreases through reduction in market value, sales and losses, thus arriving at the amount of the closing inventory.

No. 4 (20 points):

In preparing a balance-sheet, to be used in proposed refinancing of a company engaged in the production of wine, which has maintained rather incomplete records, what amount would you use as the value of finished wine on hand, on the basis of the following data?

With respect to the inventory of wine on hand you are able to determine the following:

(1) The average cost of grape juice was $1.55 per gallon, which approximates present market.

(2) The average cost of brandy, of which 5 gallons were used per 50 gallon barrel of finished wine, was $3.75 per gallon.

(3) Filtration loss was stated to be, in the aggregate, about 4 gallons to each 50 gallons—the federal government allows 6%.

(4) The total labor cost to produce 40,000 gallons in one year was $18,000.00.

(5) The cost of a 50 gallon barrel was $5.50.

(6) The plant overhead was about 1/3 of the labor cost.

(7) Shrinkage averaged about 1% per annum.

(8) Carrying charges averaged about 6% per annum.

(9) Of the 20,000 gallons of wine on hand, 5,000 gallons were 15 years old and 15,000 gallons were 6 years old.

Submit a work sheet and explain your reasoning.

No. 5 (20 points):

"A" opened a store on January 1, 1908, with a capital of $10,000. After deducting a reasonable salary for himself his profits, which were permitted to remain in the business, were as follows:

1908	$15,000	1913	$ 10,000
1909	20,000	1914	150,000
1910	30,000	1915	50,000
1911	40,000	1916	100,000
1912	60,000		

On January 1, 1917, he incorporated, and received for the net assets in the business the entire capital stock of the corporation, consisting of common stock of a total par value of $485,000.

On January 1, 1928, the company was reorganized. "A" received $1,000,000 of 6% cumulative preferred stock of $100 per share and 50,000 shares of no-par-value common stock of $485,000 stated value.

In the period from January 1, 1917, to December 31, 1927, the company had acquired for $500,000 the land and building which it occupied. On January 1, 1928, the property was appraised at $600,000 and this value was placed on the books of the reorganized company.

(a) Immediately following the reorganization on January 1, 1928, "A" sold one-half of his preferred stock for $500,000. What taxable profit or deductible loss for federal income-tax purposes did he realize from the sale?

(b) In 1930 the corporation exchanged its land and building for property in another neighborhood. The new property had a value of $600,000. Depreciation for 1928 and 1929 on the old building amounted to $5,000. What profit or loss for federal income-tax purposes was realized from this exchange?

NOTE.—Under the 1917 income-tax law goodwill was allowed as invested capital and should be considered in determining the value of the company's shares. In computing the goodwill as of any date, use invested capital and profits for the preceding five years, allow 8% return on the average capital and capitalize the balance of profit on the basis of 15%.

Examination in Commercial Law

November 17, 1933, 9 a. m. to 12:30 p. m.

An answer which does not state reasons will be considered incomplete. Whenever practicable, give answer first and then state reasons.

Group I

Answer all questions in this group.

No. 1 (10 points):

Beach drew a bill of exchange on Washburn as drawee and gave it to the payee for adequate consideration. The payee personally presented it to Washburn who immediately became enraged and tore up the bill. Against whom has the payee any right of action on the bill?

No. 2 (10 points):

O'Rourke gave a mortgage on real estate to Kenyon. The mortgage note was not paid at maturity but interest was paid currently, and the mortgage continued in force as an open one without formal renewal. The property was conveyed several times until it reached Wulff. Wulff as owner made an agreement with Kenyon as mortgagee, personally assuming the mortgage debt, extending the time for the payment of it and specifying that interest was to be paid on February 19th and on August 19th of each year. Wulff then conveyed the property to Coleman, who paid the interest for several years, each payment being made from one to five days before it was due. The mortgagee upon foreclosure sought to hold Wulff for a deficiency. Wulff defended on the ground that the payment and acceptance of interest prior to its due date amounted in each instance to an extension of the mortgage without his consent and thereby relieved him as surety. Is his defense legally sound?

No. 3 (10 points):

Miller, a diamond cutter, gave a diamond on memorandum to Falk, the written memorandum expressly providing that title was to remain in Miller until Miller approved of a sale by Falk. Falk, representing that he was the owner and without showing the written memorandum, sold the diamond to Porter for cash and then disappeared without accounting to Miller. Miller now sues

Porter to recover possession of the diamond. For whom should judgment be rendered?

No. 4 (10 points):

(a) How, in general, would you draw the line distinguishing interstate business from intrastate business?

(b) Are citizens of each state entitled to the privileges and immunities of citizens in the several states? (State the authority for your answer.)

(c) Is a corporation a citizen to which your answer to (b) applies?

No. 5 (10 points):

A retail storekeeper contracted with a newspaper to publish an advertisement in which certain articles were listed at the price of $15 each. The newspaper negligently and erroneously printed the price of these articles as $5 each. The newspaper sued the storekeeper for the contract price of the advertisement. The storekeeper set up a counterclaim that he was obliged by law to sell the articles at $5 instead of at $15 and that he thereby incurred a heavy loss. Was his counterclaim a valid defense?

Group II

Answer any five questions in this group. No credit will be given for additional answers, and if more are submitted only the first five will be considered.

No. 6 (10 points):

A promissory note, otherwise negotiable, contained a promise to pay the sum of $50,000 "in successive semi-annual payments of not less than one thousand dollars each, for a period of eight years from date, and the balance then due to be payable on demand thereafter, with interest on the principal unpaid at the rate of six per cent. per annum, payable semi-annually, together with all taxes assessed upon said sum against said payee or the holder of this note." Explain whether or not the foregoing provision affected the negotiability of the note.

No. 7 (10 points):

Defendant was the owner of a half interest in, and was director, vice-president and general manager of, a mutual casualty company, a corporation engaged in insuring owners of taxicabs against damages for personal injuries. As an inducement to plaintiff to purchase defendant's interest in said corporation, defendant gave plaintiff a written statement of the corporation's financial condition which showed a surplus of $112,201.34. In reliance upon said statement, plaintiff purchased defendant's interest, and shortly thereafter an examination by the state insurance department showed a deficit of $47,943.01 as of the date of the statement. The difference lay in the reserve for outstanding losses. The correct amount of that reserve could be determined only by examining some 6,000 pending suits and claims and placing on each a reasonable estimate of liability. No evidence was offered by defendant to show how he had determined the amount of the reserve as shown in his statement. On these facts, should defendant's statement be held fraudulent?

No. 8 (10 points):

A document entitled "Articles of agreement," duly executed, stated that the parties to it agreed to execute a formal lease of certain specified real estate for a specified term of years at a specified rental. The document provided for "the usual and proper covenants" as to possession, surrender and delivery, warranty, re-entry and the like and recited that the lease was to contain "in brief, all of the usual and formal clauses to the mutual satisfaction of the parties." Did the phrase "to the mutual satisfaction of the parties" make the document indefinite, a mere agreement to agree, and thus unenforceable as a contract?

No. 9 (10 points):

X leased a building from Y to be used as a jewelry store. Just prior to the expiration of the lease, Y contracted with Z to wreck the building. Z inspected the building prior to making his contract and in the contract he agreed to a legally enforceable penalty for delay beyond a specified date. Upon the expiration of the lease, X vacated, but he abandoned a large safe which he had placed in the basement of the building. The lease contained no provision applicable to either the installation or the removal of the safe. Z discovered the abandonment of the safe after X had vacated and notified X that he would hold X responsible for the cost of removing and disposing of the safe (which had no sale or scrap value) and also for any penalty for delay necessarily caused by the work of removing the safe. Could Z recover from X on either of these claims?

No. 10 (10 points):

A depositor in the Amalgamated Bank sued the bank to recover the amount paid by the bank upon the forged endorsement of the payee of a cheque drawn by the depositor. At the time the cheque was given to the payee, the latter gave the depositor a promissory note payable on demand for the amount of the cheque. The bank pleaded as a defense that the depositor had been negligent in not making a timely demand upon the payee of the cheque for the payment of the note. Is this a good defense?

No. 11 (10 points):

Plaintiff owned 60% of the capital stock of the Monitor Baking Corporation in the city of X. Defendant, who was president and manager of that corporation, owned 10% of its capital stock. Defendant told plaintiff that he intended to start a baking company of his own in a city over 500 miles away. Plaintiff thereupon contracted to buy defendant's stock in the Monitor Baking Corporation, making a cash payment on account and giving a note for the balance. Immediately thereafter, defendant organized and became president of a new baking corporation in the city of X which was to compete directly with the Monitor company. Before maturity of the note and prior to the transfer of the stock, plaintiff sued in equity for rescission of the contract. Is plaintiff entitled to rescission?

No. 12 (10 points):

In August, 1932, the Blake Building Corporation sold a parcel of real estate at a profit or excess over cost. The purchaser paid part of the selling price in cash and gave a note secured by a purchase-money mortgage for the balance. The cash received was less than 40% of the selling price and the corporation used the instalment basis in its 1932 federal income-tax return. In January, 1933, the corporation was dissolved and all its assets including said note were distributed to its sole stockholder.

(a) If at the time of dissolution the corporation was indebted to its sole stockholder for an amount equal to the amount of said note and the note was accepted by the stockholder in discharge of that debt, how should the corporation account for the balance of the profit on the sale in its 1933 federal income-tax return?

(b) Would your answer necessarily be the same as in (a) if said note were given to the stockholder as part of the liquidating dividend?

Examination in Accounting Theory and Practice

PART II

NOVEMBER 17, 1933, 1:30 P. M. TO 6:30 P. M.

Answer problems 1, 2, 3 and 4 and two of the problems 5, 6 and 7.

No. 1 (23 points):

The "A" Corporation (New York), with a branch in Philadelphia has a wholly owned subsidiary, the "B" Corporation, which was forced into bankruptcy on June 30, 1933. The creditors of "A" corporation formed a committee, following the application by the Dexter National Bank, Philadelphia, against its loan, of the company's balance of cash on deposit with the bank.

The following trial balances after closing, June 30, 1933, and other data were furnished to the committee by the company:

"A" Corporation (New York books)

Cash—New York Trust Co.	$ 1,524	Notes payable—	
Securities, at cost (pledged)	14,650	Dexter Nat'l. Bank, Philadelphia	$20,000
Furniture and fixtures	1,000	Loans payable—secured, per contra	12,500
Capital stock—"B" Corp.	7,500	Capital stock	25,000
Advances—"B" Corp.	14,640		
Advances—Phila. branch	15,680		
Deficit—per books	2,506		
	$57,500		$57,500

The pledged securities have a market value of $5,200 and the furniture and fixtures an appraised value of $300.

Philadelphia branch (Philadelphia books)

Cash—Dexter Nat'l. Bank, Philadelphia, per bank statement	$ 1,580	Accounts payable	$19,060
Accounts receivable	10,000	Wages payable	1,550
Merchandise inventory, June 30, 1933	9,500	Taxes payable	800
Furniture and fixtures	7,500	Due to "A" Corp.	15,680
Profit and loss	8,510		
	$37,090		$37,090

The sale of the assets should realize the following: accounts receivable $6,200; merchandise $4,675; furniture and fixtures $2,500.

The cost of liquidation for New York and Philadelphia should be about $4,000.

Receiver and trustee administrative expenses of "B" are estimated at $5,000. Cheques for $4,520 to merchandise creditors, on which payment was stopped when bank applied cash on deposit against its loan, have not been adjusted on "B" 's trial balance.

"B" Corporation—Alleged bankrupt
Assets are at estimated realizable value

Accounts receivable	$ 5,582	Overdraft—Camden bank	$ 1,600
Land and building	9,860	Loan payable—Camden bank	7,000
Merchandise inventory, June 30, 1933	7,500	Store wages payable	540
Furniture and fixtures	1,230	Office salaries payable	200
John Doe, president—loan account	300	Executive salary payable—President	1,800
Deficit	34,388		
		Mortgage payable	12,000
		Mortgage interest accrued	240
		Real estate taxes payable	530
		Accounts payable	12,810
		"A" Corporation	14,640
		Capital stock	7,500
	$58,860		$58,860

The salary of John Doe, the president, is $6,000 per annum. The store wages and office salaries are for the two weeks ending June 30, 1933. The "A" Corporation is guarantor on the mortgage and "B" Corporation is on the mortgage bond.

Having engaged your services, the committee has instructed you to prepare, from the above information, statements showing (a) the probable amount which should be available for unsecured claims against "B" Corporation, and (b) the probable amount which should be available for creditors of "A" Corporation in the event of liquidation.

No. 2 (30 points):

You are appointed by the board of directors to examine the accounts relating to the assets and liabilities of The Goodenough Corporation, New York, and its domestic subsidiaries, as at December 31, 1932.

Prepare a consolidated balance-sheet as at December 31, 1932.

The Goodenough Corporation has one foreign subsidiary (wholly owned), the accounts of which have been examined by another firm of accountants whose report, which has been submitted to you, is as follows:

THE BRITISH GOODENOUGH COMPANY, LTD.
Balance-sheet as at December 31, 1932
Liabilities

Share capital:	
Authorized:	
600,000 shares of £1 each	£600,000

Issued:		
600,000 shares of £1 each		£600,000
Current trade liabilities		78,500
Reserve for income tax payable:		
Due January 1, 1933		90,000
Due January 1, 1934		74,500
Indebtedness to affiliated company		2,500
Profit-and-loss appropriation account:		
Balance January 1, 1932	£ 12,145	
Net profit for year	298,000	
	£310,145	
Less: Dividends	200,000	110,145
Total		£955,645

Note.—There is a liability not included in this balance-sheet in respect to machinery which this company has agreed to purchase.

Assets

Property, plant and equipment at cost, less reserve of £250,000 for depreciation	£450,000
Stock on hand at cost	170,000
Customers' accounts receivable, less reserve of £10,000 for bad and doubtful accounts	250,383
Cash at bank and in hand (Of this amount the sum of £80,000 is earmarked for a guarantee given on behalf of the company) ...	85,262
Total	£955,645

Auditor's report

We report to the members that we have examined the above balance-sheet with the books of the company and have obtained all the information and explanation we have required. We are not satisfied as to the adequacy of the reserve for bad and doubtful accounts.

Subject to this remark we are of opinion that the balance-sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as at December 31, 1932, according to the best of our information and explanations given to us, and as shown by the books of the company.

A. B. C. and Co.

London, England,
January 31, 1933

You have communicated with the English company and with its auditors and have ascertained the following:

(a) With the exception of machinery costing £100,000, which was installed in November, 1932, when the average rate of exchange was \$3.50, the property, plant and equipment were acquired when the company was formed, when the rate of exchange was at par (\$4.86). The established policy of the company is to charge a full year's depreciation on additions made in the first six months of any year and to charge depreciation commencing January 1st of the year following the year of addition on additions made in the second six months of any year.

(b) Of the stock on hand £160,000 represents goods purchased from The Goodenough Corporation, the parent company, at its cost of $540,000 plus freight to England of $36,000 paid by the parent company at the time of shipment. Cost of the remaining £10,000 of British stock approximated market at December 31, 1932. (Note: There had been no change in freight rates to December 31, 1932, and the rate of exchange on that date was $3.40. You find that The Goodenough Corporation had reduced the cost of its inventory by 10% in order to reflect the lower of cost or market value as at December 31, 1932. The directors have agreed that for the purpose of the consolidated balance-sheet the inventory as a whole should be valued at the lower of cost or market value.)

(c) The auditors of The British Goodenough Company, Ltd. feel that an additional reserve of £50,000 should be provided against the accounts receivable. Neither the directors of the British company nor those of the American corporation can agree that any further reserve is necessary.

(d) The note on the British balance-sheet refers to machinery which it has been agreed shall be purchased from the parent company at its cost less depreciation—net $120,000.

As a result of your examination of the accounts of The Goodenough Corporation and its domestic subsidiaries, you have prepared the following consolidated trial balance as at December 31, 1932, together with your list of audit notes:

Consolidated trial balance as at December 31, 1932

	DR.	CR.
Cash in banks and on hand	$ 880,000	
U. S. government securities	504,000	
Accounts receivable	1,910,000	
Reserve for doubtful accounts		$ 210,000
Inventories	1,325,000	
Property, plant and equipment	6,600,000	
Reserve for depreciation		2,500,000
Company's own shares	275,000	
Due from The British Goodenough Company, Ltd.	10,000	
Accounts payable and accrued liabilities		2,320,000
Provision for federal income tax		275,000
Dividend of 50 cents a share payable Jan. 2, 1933		500,000
Capital stock—common, no par, authorized and issued		5,000 000
Surplus		3,615,000
Investment in subsidiary company at cost	2,916,000	
	$14,420,000	$14,420,000

Audit notes

(1) Cash includes a special deposit of $100,000 in the Y Bank & Trust Company. This deposit is subordinate to claims of all other depositors but not to claims of stockholders.

(2) The government securities are stated at cost, although the market value at December 31, 1932, was only $490,000. However, on February 28, 1933, the market value had recovered to $507,000.

(3) The inter-company account is debited or credited at the actual rate of exchange on the date of each transaction, but the balance at the end of each month is adjusted on the books of the parent company by a debit or credit to profit-and-loss account, to bring the account to the basis of a fixed rate of exchange, viz., $4. The actual dollar cost of the £2,500 shown on the British company's balance-sheet was $9,250. There were no items in transit.

(4) In addition to customers' accounts the following items are included in accounts receivable:

(a) Loan to officer $87,000.

(b) Customers' accounts aggregating $370,000, on which payments are deferred by special arrangement until 1934: $50,000 of reserve is allotted to these accounts.

(5) Company's own shares represent 7,000 shares carried at cost and held for resale to employees under employees' stock purchase plan. The market value on December 31, 1932, was $3 per share but the directors will not agree to writing down this asset to market value.

(6) The life of Mr. B., President, is insured for $1,000,000 in favor of the company and the policy at December 31, 1932, had a cash-surrender value of $75,000. All premiums have been charged to expense, as the directors object to setting up cash-surrender value on the books.

(7) There are claims pending against the company which are estimated not to exceed $150,000.

(8) The property, plant and equipment accounts are stated at cost.

(9) Accounts payable include employees' savings deposits, $392,000.

No. 3 (25 points):

On the basis of the following information prepare:

1. An assembly sheet in columnar form to arrive at the figures for the assets and liabilities of the "New Company."

No journal entries, formal balance-sheet or work schedules are required.

2. A statement showing the items of which the capital surplus of the "New Company" is composed.

The P Company was an operating and holding company whose position at October 1, 1932, was shown by the following balance-sheet:

Assets	
Cash	$ 150,000
Accounts receivable, less reserve	200,000
Inventories	750,000
Marketable securities—present value	500,000
Investment in subsidiary companies	4,700,000
Fixed assets, less depreciation	8,000,000
Prepaid expenses	50,000
Deficit	1,300,000
	$15,650,000

Liabilities	
Accounts payable	$ 300,000
Bank loan	1,000,000
Trade notes payable	170,000
Unpaid bond interest	280,000
First-mortgage 7% bonds	4,000,000
Eight per cent. cum. preferred stock (unpaid dividend $160,000)	2,000,000
Common stock 1,240,000 shares no par	7,900,000
	$15,650,000

The P Company had three subsidiaries. It owned the entire capital stock of the "A", the "B" and the "C" companies and all the bonds of the "A" Company. Their balance-sheets at October 1, 1932, were as follows:

Assets	"A" Company	"B" Company	"C" Company
Cash	$ 50,000	$ 20,000	$ 25,000
Accounts receivable, less reserve	10,000	1,000	2,000
Inventories	250,000	150,000	300,000
Land	2,300,000	1,400,000	1,000,000
Buildings, plant and equipment	700,000	350,000	200,000
Prepaid expenses	20,000	2,000	4,000
Deficit	200,000	70,000	120,000
	$3,530,000	$1,993,000	$1,651,000

Liabilities	"A" Company	"B" Company	"C" Company
Accounts payable	$ 30,000	$ 10,000	$ 15,000
Notes payable	50,000		100,000
Unpaid bond interest		90,000	48,000
First-mortgage 6% gold bonds	1,800,000	1,000,000	800,000
Reserve for depreciation	150,000	93,000	88,000
Capital stock, $100 par	1,500,000	800,000	600,000
	$3,530,000	$1,993,000	$1,651,000

Each of the four mortgages covered land, building, plant and equipment but none of the other assets.

The P Company and its subsidiaries—excepting the A Company—had defaulted on mortgage interest and the P Company had not paid its preferred-stock dividends for the last four quarters. The outside holders of the several securities formed protective committees, and to forestall a receivership a reorganization committee was appointed to outline a rehabilitation plan. Under this plan the outside holders deposited their securities with a trustee. However, the bondholders of the C Company withdrew from the plan and foreclosed their mortgage. They recovered their claim in full, but nothing was left over.

The finally accepted reorganization scheme provided for the formation of a "New" company with 1,000,000 shares no-par-value stock to be set up at $5 per share. Part of this stock was to be issued in exchange for the deposited securities as follows:

Holders of P Company bonds were to get 175 shares and those of B Company bonds 130 shares for each $1,000 bonds including unpaid interest.

Holders of P Company preferred stock were to get 6 shares for each share of $100 par value including unpaid dividend.

To procure additional working capital $5,000,000 new 7% first-mortgage bonds were authorized, of which $2,500,000 were to be issued at 90. A bonus of 10 shares of the new stock was to go with each $200 of new bonds.

The creditor bank agreed to underwrite the above issue subject to the rights of old and new bond and stock holders and provided that the loan of $1,500,000 be paid out of the proceeds. The remainder of the capital stock was to be issued later in accordance with subscription rights given to the common stock holders.

The three sub-companies were dissolved and the New Company took over the assets and assumed the liabilities of the old companies in accordance with the plan and subject to the foreclosure on the C Company property. Fixed assets with relative depreciation were taken over at 50% of book value and the A Company mortgage was cancelled by the P Company. A reserve of $500,000 was set up for contingencies, such as loss on inventories, etc. Reorganization expenses were $100,000.

No. 4 (10 points):

The following is a statement of the profit and loss of the Lacdun Company for the year ended August 31, 1933:

Sales		$600,000
Cost of sales:		
Materials	$195,000	
Direct labor	130,000	
Factory expense	65,000	390,000
Gross profit		$210,000
Selling expenses		$ 90,000
Administrative and general expenses		40,000
		$130,000
Net profit		$ 80,000

For the year ending August 31, 1934, it is expected that the sales will increase $33\frac{1}{3}\%$ in volume, while selling and general expense, as well as the production costs, are estimated to advance as follows:

The cost of materials and direct wages are expected to go up 20%, but there will be a reduction of 10% in the material content of the finished product.

Factory expense is expected to be relatively 15% higher.

Selling expense is expected to increase 20% and general expense 25%.

By what percentage must the selling price be increased in order that the net profit for the year ending August 31, 1934, shall exceed that of the previous year by 25%?

No. 5 (6 points):

The premiums on a fire-insurance policy covering a certain building for the amount of $500,000 on a one-year, three-year and five-year basis are as follows:

One year	$1,120
Three years	2,800
Five years	4,480

In each case the entire premium for the full term of the policy is payable in advance.

You are asked to compute the annual cost of this insurance to the insured on each of the three bases, assuming that money is worth 6% per annum.

Given:

P 1 at 6% = .9434
P 2 at 6% = .8900
P 3 at 6% = .8396
P 4 at 6% = .7921
P 5 at 6% = .7473

NOTE.—P 1 is the present value of $1.00 at 6% compound discount for one period; P 2 for two periods, etc.

No. 6 (6 points):

Using the data given below, calculate the inventory for a department store, December 31, 1932, by the "retail" method:

	Cost	Original sales price
Inventory, December 31st, 1931	$150,000	$297,000
Purchases 1932	400,000	752,000

Mark-ups during the year not included in above sales price were $15,000.

Mark-downs during the year not included in above sales price were $27,500.

Mark-on percentages are to be considered as uniform among the departments; other factors are equal.

Net sales for the year were $725,000.

Cost of sales for the year was $398,500.

No. 7 (6 points):

The B & D Corporation's balance-sheet of May 31, 1933 shows the following items:

Assets	
Current assets	$ 10,000
Fixed assets	12,000
Formulæ and goodwill	500,000
Total	$522,000
Liabilities	
Current liabilities	$ 7,000
Capital stock—common	100,000
Surplus	415,000
	$522,000

You find upon examination that the surplus item of $415,000 consists of "earned surplus" $15,000 and "capital surplus" $400,000.

You are informed that the corporation pays exceptionally large salaries to its officers and that as a result its net earnings average only about two thousand dollars per annum.

In preparing the 1933 "Return of capital-stock tax" of the B & D Corporation for the year ended June 30, 1933, under sections 215 (capital-stock tax of 1.00 per 1,000) and 216 (excess-profits tax of 5 %) of the national industrial recovery act, what factors would you take into consideration in advising the president? Would you suggest a figure at which to declare the value of the capital stock? State reasons for your answer.