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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, May 17 and 18, 1934.]

Examination in Auditing

MAY 17, 1934, 9 A. M. TO 12:30 P. M.

Answer the first nine questions and either of the last two.

No. 1 (10 points):

(a) What is a "hidden" or "secret" reserve?

(b) When intentionally created, what four reasons, valid or not, are usually advanced in justification?

(c) Should an auditor ever approve such reserves?

No. 2 (10 points):

The American Institute of Accountants has suggested and the New York Stock Exchange has adopted the following form of report to be used instead of the ordinary "short certificate," viz.:

ACCOUNTANTS' REPORT

"To the XYZ Company:

"We have made an examination of the balance-sheet of the XYZ Company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

"In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year."

Compare the above form with the ordinary "short certificate," and state what advantages, in your opinion, it has over the latter.

No. 3 (10 points):

You are employed by a small firm of retail dealers to close its books for the year and prepare a profit-and-loss statement and a

balance-sheet. You are not expected to verify the accounts beyond making corrections of obvious errors, such as postings to wrong account and the like.

How should you protect yourself from having the firm use your statements for credit purposes as having been audited by you?

No. 4 (10 points):

The total amount of the inventory of merchandise of a trading concern has been increasing each year for the last three years while the gross profits have been diminishing.

(a) State the probable reasons for this; and

(b) How you would proceed to discover the real cause.

No. 5 (10 points):

If inventory declines in value between the date of statement and that of certification, and the concern audited has a potential loss on purchase commitments, what is the responsibility of the auditor to indicate the loss as of certification date?

No. 6 (10 points):

You are engaged by the directors to make a balance-sheet audit of the X Bank at the close of 1933. You are expressly requested to refrain from seeking confirmation from depositors or borrowers, owing to public nervousness caused by the recent failure of another bank in the town, the clients of the X Bank being mainly of the working class unfamiliar with auditing procedure.

At the closing hour on December 30, 1933, you appear at the bank and the head bookkeeper hands you the following:

Balance-sheet, December 30, 1933

Assets		*Liabilities*	
Cash on hand	$ 50,000	Notes payable	$ 25,000
Due from banks	80,000	Due to banks	5,000
Stocks and bonds	100,000	Deposits: demand	530,000
Mortgages owned	200,000	" savings fund	420,000
Loans and discounts	600,000	Capital stock	200,000
Accrued int. receiv'l	10,000	Surplus	100,000
Bank building	50,000	Undivided profits	21,000
Furn. and fixtures	10,000		
Real estate foreclosed	100,000		
Federal deposit ins.	1,000		
	$1,301,000		$1,301,000

State how you will proceed to verify the items on the above balance-sheet.

No. 7 (10 points):

In preparing the income-tax return for a state bank you find it has been compelled by the state banking department to write down its stocks and bonds owned to market values as of March 31, 1933, an average reduction of 70%, resulting in showing a heavy book loss. Otherwise the bank's operations for the year would show a small profit. To avoid the federal tax the bank wishes to include the heavy mark-downs as a deduction in its return.

What would you advise, and why?

No. 8 (10 points):

What general procedure should be followed in arriving at a fair valuation of—

(a) Plant account.
(b) Investments.
(c) Patents.
(d) Sinking fund to retire bonds?

No. 9 (10 points):

After a stormy stockholders' meeting and quarrels among the directors, you are engaged by the officers of a corporation to make a balance-sheet audit, the first in the corporation's existence of several years. You find the financial records in order and are ready to certify the balance-sheet, but the officers refuse to produce the minute-book for your inspection, offering instead to furnish you with attested copies of such resolutions as you deem necessary to verify certain items.

What will be your attitude in the matter? State your reasons fully.

No. 10 (10 points):

What is the proper handling of merchandise on consignment in a financial statement prepared for the consignor?

No. 11 (10 points):

You are asked by a client to undertake the recovery of an overpayment of federal income-tax which was due to alleged errors in the return. As an inducement he offers to give you half the amount recovered as your fee. What would be your reply? Give your reasons.

Examination in Accounting Theory and Practice

PART I

MAY 17, 1934, 1:30 P. M. TO 6:30 P. M.

Solve problems 1, 2 and 3 and either 4 or 5.

No. 1 (35 points):

From the accounts and information given below prepare:

(a) Consolidated balance-sheet.
(b) Consolidated goodwill and capital surplus account.
(c) Consolidated earned surplus account.
(d) Any necessary comments required for correct interpretation of the accounts as presented.

BALANCE-SHEETS, December 31, 1933

	A Company	B Company	D Company
Accounts receivable	$ 346,480	$ 132,740	$ 68,740
Cash surrender value of life-insurance policies	15,480		
Cash in bank	224,682	59,420	9,720
Deferred charges	14,620	6,232	2,740
Inventories	462,000	267,032	109,630
Investment in B Company—4,000 shares at cost	600,000		
Investment in D Company—800 shares at cost		200,000	
Land, buildings, machinery and equipment	897,306	408,784	273,086
Receivable from D Company		16,836	
	$2,560,568	$1,091,044	$463,916
Accounts payable	$ 326,740	$ 127,630	$ 96,940
Reserve for depreciation	370,620	138,760	96,320
Reserve for bad debts	38,000	17,000	10,000
Capital stock—common:			
10,000 shares of $100 each	1,000,000		
5,000 shares of $100 each		500,000	
1,000 shares of $100 each			100,000
Earned surplus	825,208	307,654	143,820
Payable to B Company			16,836
	$2,560,568	$1,091,044	$463,916

Earned Surplus Accounts

Surplus as at December 31, 1931	$ 720,808	$ 285,672	$126,948
Net operating income:			
Six months ended June 30, 1932	8,260	2,762	974
Six months ended December 31, 1932	12,390	4,710	2,978
Dividends on B Company stock received September 30, 1933	20,000		
Excess of proceeds of sale of E Company stock over cost	50,000		
Net operating income:			
Six months ended June 30, 1933	32,640	11,690	3,276
Six months ended December 31, 1933	81,110	27,820	9,644
	$ 925,208	$ 332,654	$143,820
Dividends paid	100,000	25,000	
Earned surplus per books December 31, 1933	$ 825,208	$ 307,654	$143,820

The A Company acquired 3,750 shares of common stock of the B Company on January 1, 1933, and a further acquisition was made of 250 shares on June 30, 1933, the cost price in both cases being $150 a share. The B Company acquired 800 shares of the D Company—an 80% interest—on June 30, 1932, for $200,000.

The A Company owned all of the capital stock of the E Company from June 30, 1927, to September 30, 1933. At the latter date the stock was sold for $100,000, or $50,000 more than the purchase price. The net worth of the E Company amounted to $60,460 on June 30, 1927. By December 31, 1932, it had increased through earnings to $87,630 and by September 30, 1933, it showed further earnings, the capital and surplus then amounting to $93,920.

The inventory of the A Company at December 31, 1932, contained merchandise acquired from the E Company, valued at $18,700, the sum billed by the latter company. The goods had been produced by the E Company at a cost of $17,000.

No. 2 (30 points):

As at December 31, 1931, the Pacific Company revalued all of its fixed property on the basis of estimated present replacement cost ("cost to replace new") and the application thereto of accrued depreciation computed according to the expired portion of the estimated life of each item as then determined. The difference between the depreciated value of the fixed assets, as shown by the books, and the depreciated replacement cost, was charged to "earned surplus" and credited to "reserve for revaluation of

fixed assets," it being the company's intention to show depreciation in the profit-and-loss account, in future, as follows:

Depreciation based on old book values and revised lives	$........
Less: Credit from "reserve for revaluation of fixed assets"................................	....
	$........

No depreciation has been or is to be charged in the year of acquisition, but a full year's depreciation is to be charged in the year of expiration or abandonment. The policy of the company has been to depreciate its fixed assets on the basis of estimated life and to revise these estimates from time to time as conditions warrant. From the following statement prepare:

(1) Annual charges for depreciation and property losses for 1932 and 1933.

(2) Statement of "reserve for revaluation of fixed assets account" for the two years ended December 31, 1933.

						Revaluation Dec. 31, 1931	
Item	Date of purchase	Cost	Original estimated life	Estimated salvage value	Dep'n reserve Dec. 31, 1931 per books	Replacement cost	Revised life from Dec. 31, 1931
1	1919	$100,000	25 years	$10,000	52,000	70,000	12 years
2	1920	700,000	25 "	40,000	350,000	400,000	9 "
3	"	25,000	20 "	2,000	14,000	20,000	4 "
4	"	75,000	20 "	3,000	37,500	48,000	4 "
5	1923	200,000	15 "	12,000	140,000	140,000	12 "
6	"	50,000	20 "	3,000	22,500	40,000	12 "
7	1924	400,000	25 "	12,000	148,000	300,000	23 "
8	1925	50,000	20 "	2,000	18,000	45,000	14 "
9	1926	100,000	15 "	5,000	40,000	85,000	15 "
10	"	20,000	25 "	2,000	4,800	18,000	15 "

No change was made in salvage values when the fixed assets were revalued.

Item 1 was totally destroyed by fire December 31, 1932.

Item 7 was totally destroyed by fire December 31, 1933.

No. 3 (15 points):

A B C Co., patentee and subsidiary of John Doe & Co., assembled and sold a patented machine for which all the parts were made by and bought from John Doe & Co.

During five years of operations, A B C Co. had sold 2,800 machines at $3,000 each and had made a gross profit of $500 a machine after deducting its overhead of 25% of direct costs. Included in these costs was $1,500 a machine for parts and this in-

cluded a gross profit of $200 to John Doe & Co., whose overhead ran to 30% of its direct costs.

Both John Doe & Co. and the A B C Co. were equipped to make and sell without additional overhead 25% more machines than had been sold.

A B C Co. together with John Doe & Co., had sued an infringing company for damages representing loss of business and consequent loss of profit. The infringing company had made and sold 460 machines at $2,500 each in the same period and the A B C Co. obtained judgment for the full amount of its claim and costs.

X Y Co., the infringer, organized solely for the assembly and sale of the machine, was a subsidiary of the Z Co. (made co-defendant). The latter company made and sold the infringer all the parts for the infringing machine. The books of the X Y Co. showed the following figures:

	Net profit	Cost of parts	Overhead
1st year	$ 25,000	$ 77,000	$ 23,000
2nd year	50,000	148,500	51,500
3rd year	60,000	187,000	53,000
4th year	55,000	165,000	55,000
5th year	40,000	115,500	44,500
	$230,000	$693,000	$227,000

The sales to the X Y Co. included 10% profit to the Z Co. The X Y Co.'s closing inventory of $25,300 was taken at invoiced cost and consisted of unassembled parts. The Z Co. had no inventory.

The X Y Co. satisfied the judgment in full.

(1) What was the amount for which the A B C Co. on behalf of itself and its parent company sued the X Y Co. and its parent Z Company?

(2) How much did the latter two lose or make, excluding costs of suit, interest and any scrap value?

No. 4 (20 points):

On June 30, 1931, Company A acquires Company B, which uses as its raw material some of the product of Company A.

On September 30, 1931, Company A acquires Company C which uses as its raw material some of the product of Company A and Company B.

Calculate from the following data:

(1) The consolidated profit for the year 1931.
(2) The amount of profit of Companies B and C that is to be treated as a part of the consolidated capital surplus.

	1930	1931
Total sales, including intercompany sales:		
Company A	$3,780,000	$4,380,000
" B	1,300,000	1,100,000
Gross profits:		
Company A	415,800	394,200
" B	228,300	220,000
" C	(not given)	46,000
Purchases from Company A		
Company B	470,000	367,000

Materials included in closing inventories:	1929	1930	1931
Company A materials:			
In Company B inventory	$113,000	$113,000	$110,000
In Company C inventory	(not given)	24,000	22,000
Company B materials:			
In Company C inventory	(not given)	166,000	120,000

No other information can be procured. It is assumed (1) that all sales to associated companies are made at the same price as the sales to others, (2) that each company sells its goods throughout the year at its average rate of gross profit for the year and (3) that the sales are ratably distributed over the months of the year.

No. 5 (20 points):

On the basis of the following profit-and-loss account of the Excelsior Company and summaries of agreements with Jones and Smith, employees, compute the commissions payable to the latter for the year 1933.

EXCELSIOR COMPANY

Profit-and-loss account for the year ended December 31, 1933

Gross profit before depreciation		$150,000
Depreciation		30,000
Gross profit		$120,000
Selling and administrative expenses (including $2,000 for state taxes)		94,000
		$26,000
Other income, interest, etc.	$25,000	
Less: Interest on mortgage	20,000	5,000
		$31,000
Capital stock tax		1,000
Net profit before special commissions and federal income tax		$30,000

Agreement with Jones:

Special commission to be equal to 15% of the net profit transferred to surplus.

Agreement with Smith:

Special commission to be equal to 15% of the net profit before charging federal and state taxes, interest on mortgage and the commission payable to Smith under this agreement, but after charging, for the purpose of computing this commission only, additional depreciation of $20,000.

Complete the profit-and-loss account and show separately the charges for commission and federal income tax, using 14½% as the rate of income tax.

Examination in Commercial Law

May 18, 1934, 9 a. m. to 12:30 p. m.

Reasons must be stated for each answer. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question, rather than on his conclusions.

Group I

Answer all questions in this group.

No. 1 (10 points):

Williams, a patent lawyer, was rendering legal services to Young on applications for patents which Young had made. Prior to the issue of the patents, Young made a contract with Bostwick whereby Bostwick agreed to conduct and pay for further prosecution of the applications. In this contract no mention was made of Williams or of any other patent lawyer. Williams knew that the contract was made and in reliance upon it he thereafter rendered legal services in the further prosecution of the applications but without the knowledge or consent of Bostwick or Young. Williams sued Bostwick on the theory that Williams was a third party beneficiary under the contract. For whom should judgment be rendered?

No. 2 (10 points):

A savings bank received a letter purporting to be signed by one of its depositors and enclosing that depositor's pass-book. The letter contained a request that a cheque for part of the balance of the account be mailed to him at an address in another state. The bank as requested mailed the cheque and the pass-book,

enclosing them with a letter addressed to the depositor. The cheque was presented to the drawee national bank by the writer of the first letter, and he identified himself by showing the depositor's pass-book and the letter written by the savings bank. The national bank paid the cheque. Subsequently the savings bank learned that its depositor's pass-book had been stolen and that the letter purporting to be from him was a forgery. Can the savings bank recover the amount of the cheque from the national bank?

No. 3 (10 points):

Each of the following paragraphs purports to summarize the law on the point involved. State as to each of them whether or not it is correct; if any one is incorrect restate it; and in each instance give the legal reasons on which the rule is based:

(a) A stockholder has a pre-emptive right to participate ratably with other stockholders in subscribing for new shares when the corporation's capital stock is increased and new stock is issued.

(b) A stockholder has the same right with respect to authorized but unissued stock.

(c) A stockholder has the same right with respect to treasury stock acquired by the corporation with the intention of reissuing it.

(d) A stockholder has the same right with respect to treasury stock, acquired by the corporation with the intention of retiring it, which later is offered to investors.

No. 4 (10 points):

Plaintiff entrusted securities to defendant, a stockbroker, for safe-keeping. Plaintiff was not dealing on margin and he was not indebted to defendant in any amount, and defendant charged plaintiff a reasonable fee for his custodianship. Plaintiff gave defendant no authority to hypothecate these securities, but defendant nevertheless pledged them as security for a loan. Defendant became bankrupt and the pledgee of the securities legally and in due form sold them. Plaintiff now sues defendant for the value of the securities and defendant pleads his discharge in bankruptcy as a defense. Discuss the validity of this defense on each of the following assumptions:

(a) Defendant hypothecated the securities wilfully and maliciously;

(b) Defendant hypothecated them through an innocent but mistaken belief that the securities belonged to defendant.

No. 5 (10 points):

Stern, by a written instrument, legally guaranteed the payment by Colt of all charges for goods purchased from the Emporia Company. Colt failed to pay certain proper charges and the Emporia Company sued Colt. During the trial, the case was settled and discontinued upon Colt's written agreement to pay a stated amount in specific instalments, with the proviso that the entire balance of the stated amount would become due upon default in the payment of any instalment. Thereafter Colt defaulted in his second instalment. Is Stern liable on his guarantee?

Group II

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

No. 6 (10 points):

Jordan was a salesman on commission with a drawing account. In March, 1932, he was discharged and a dispute arose between him and his employer as to the amount due him. On April 7, 1932, the employer gave Jordan a cheque for $390, marked "Final" on its face and endorsed "Payment in full for commissions earned or to be earned and/or all claims to date." Jordan added to this "Also subject to Mr. Jordan's letter of 4/7/32," endorsed the cheque and cashed it. In his letter of April 7, 1932, Jordan wrote his employer that he was "compelled to receive this cheque under protest subject to adjustment of my account." Did Jordan's acceptance of this cheque constitute an accord and satisfaction?

No. 7 (10 points):

The president of a corporation had power under the by-laws to appoint, to remove and to fix the compensation of employees. Without express authorization from or ratification by the board of directors he made a contract with Jones whereby the corporation was to employ Jones for life. Was this contract binding upon the corporation?

No. 8 (10 points):

The X Dress Corporation made a promissory note payable to the order of "ourselves." Brown was president of that corporation and as such he signed the note. The note was endorsed before maturity by the maker corporation and by Brown individually. Prior to the due date of the note, the X Dress Corporation made an assignment of its assets for the benefit of creditors and said assignment was executed by Brown as president. The note was not paid at maturity and the maker corporation and Brown individually were sued. Notice of dishonor of the note had not been given to Brown. Can Brown be held as endorser?

No. 9 (10 points):

The securities act of 1933 provides that in certain cases of untrue statements or omissions of statements which should have been made, certain persons "may, either at law or in equity, in any court of competent jurisdiction, sue" an accountant who has prepared or certified any part of the registration statement.

(a) Explain what is meant by equity and how it differs from law.

(b) What is the most common remedy obtainable only in equity?

No. 10 (10 points):

Define briefly the following terms (do not discuss or give examples):

(a) last will and testament
(b) legacy
(c) testamentary trustee
(d) principal of trust
(e) life-tenant
(f) remainderman

No. 11 (10 points):

(a) Define and differentiate condition precedent and condition subsequent.

(b) Define and differentiate representation and warranty.

No. 12 (10 points):

Edward Brown was secretary of Charles Brown, Inc., and owned one quarter of its capital stock, and his father owned three quarters of it. This corporation was engaged in the grain business in the middle west. In 1922, the corporation was adjudged an involuntary bankrupt, Edward Brown was adjudged a voluntary bankrupt, and each was discharged from existing debts. Thereafter Edward Brown made a contract with another cor-

poration to buy grain for it on a commission basis. In order to reëstablish his standing and credit and revive business relationships with former customers of Charles Brown, Inc., he personally paid most of the business debts of Charles Brown, Inc., which had been discharged in bankruptcy. Can Edward Brown deduct these payments from his commission income on his federal income-tax returns for the years in which he made the payments?

Examination in Accounting Theory and Practice

PART II

MAY 18, 1934, 1:30 P. M. TO 6:30 P. M.

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

No. 1 (24 points):

The Mammoth Company has owned a controlling interest in the Glendale Company since the latter company's organization on January 1, 1920, and in its annual published accounts has shown this interest as a single item under "investments." On January 1, 1933, in continuance of its policy to buy up all available outstanding capital stock and debentures of the Glendale Company, the Mammoth Company acquired an additional 53 shares of preferred stock for $2,190. On July 1, 1933, the latter company purchased $23,000 par value of debentures for $20,000 and returned to the Glendale Company for retirement $5,000 par value of debentures. The following statement shows particulars of the Mammoth Company's book record of its interest on December 31, 1933 and 1932.

Investment in and advances to Glendale Company

	December 31, 1933		December 31, 1932	
	Owned	Carried at	Owned	Carried at
Common stock at cost, January 1, 1920, less $980,000 written off to operations......	19,900 shares	$ 15,000	19,900 shares	$ 15,000
Preferred stock at cost.	14,053 "	602,190	14,000 "	600,000
Debentures at cost....	$78,000 par	76,000	$60,000 par	61,000
		$ 693,190		$ 676,000
Current account	$5,150,000		$5,275,000	
Less—Written off to operations.........	4,125,000	1,025,000	4,125,000	1,150,000
		$1,718,190		$1,826,000

The directors of the Mammoth Company have decided that on December 31, 1933, instead of showing the investment in and advances to Glendale Company as a single item in the Mammoth Company's balance-sheet, the assets and liabilities of the Glendale Company shall be included with those of the Mammoth Company, according to their character, as current assets, fixed assets, debentures or otherwise. As auditor of the Mammoth Company you are in complete accord with this procedure, but you can not accept without verification the following figures which have been included in the consolidation of December 31, 1933, and are presented as being taken from the Glendale Company's balance-sheet of that date.

Current assets	$ 692,100
Fixed assets	3,098,500
	$3,790,600
Current liabilities	$ 159,600
Debentures due January 1, 1950	650,000
Earned surplus	1,155,000
	$1,964,600

In support of the above figures the following balance-sheets of the Glendale Company are submitted:

BALANCE-SHEETS OF GLENDALE COMPANY

	December 31	
	1933	1932
Current assets	$ 692,100	$ 236,500
Fixed assets, less depreciation	3,098,500	3,698,500
Total	$3,790,600	$3,935,000
Current liabilities	$ 159,600	$ 64,000
Debentures outstanding, due January 1, 1950	650,000	700,000
Due to Mammoth Company	7,519,000	7,240,000
Capital stock:		
Common—20,000 shares of $50 each	1,000,000	1,000,000
Preferred—16,000 shares of $50 each	800,000	800,000
Deficit from operations	*6,338,000*	*5,869,000*
Total	$3,790,600	$3,935,000

In the course of your examination you have ascertained:

(1) That up to and including December 31, 1932, the Glendale Company has credited $1,965,000 interest to its account with the Mammoth Company but that the Mammoth Company has not taken up this interest.

(2) That no depreciation has been provided by the Glendale Company for the period from January 1, 1920, to December 31, 1932, although it is agreed that depreciation of $100,000 per annum should have been provided.

(3) That the net loss of the Glendale Company for the year ended December 31, 1933, is $469,000, after charging $600,000 for depreciation, $404,000 for interest on current account with the Mammoth Company and $40,500 for interest on debentures.

(4) That the write-offs on the Mammoth Company's books were intended to reduce the investment to its share of the book value of the Glendale Company's net assets, less depreciation on fixed assets at the rate of $100,000 per annum.

You are required to submit:

1. A December 31, 1933, balance-sheet of the Glendale Company prepared for ready consolidation with the Mammoth Company's balance-sheet of that date.
2. The investment, current and other accounts on the Mammoth Company's books with the adjustments and changes that will make the record clearer and bring it into agreement with the facts disclosed by the adjusted Glendale Company's books on December 31, 1933.

No. 2 (22 points):

From the following balance-sheets and income accounts of the Universal Machinery Company and its Canadian subsidiary company prepare a consolidated balance-sheet and income account and submit the working papers relative thereto:

UNIVERSAL MACHINERY COMPANY

Balance-sheet, December 31, 1932

Assets

Land	$ 130,000
Buildings and equipment	400,000
Investment in Universal Machinery Company of Canada, Ltd	200,000
Advances to Universal Machinery Company of Canada, Ltd.	30,000
Investment in stock of Universal Machinery Company—500 shares at cost	10,000
Inventories	260,000
Accounts receivable	240,000
Cash	150,000
Deferred charges	25,000
	$1,445,000

Liabilities

Capital stock:		
Common, no par value, 10,000 shares outstanding		$1,000,000
Reserves for depreciation		110,000
Accounts payable		185,000
Surplus:		
Balance January 1, 1932	$140,000	
Net profit for year	70,000	
	$210,000	
Dividend paid—$6 a share	60,000	
		$ 150,000
Balance December 31, 1932		$1,445,000

UNIVERSAL MACHINERY COMPANY OF CANADA, LTD.

Balance-sheet, December 31, 1932

(Accounts stated in Canadian currency)

Assets

Land	$ 55,000
Buildings and equipment	130,000
Inventories	80,000
Accounts receivable	60,000
Cash	50,000
Deferred charges	5,000
	$ 380,000

Liabilities

Capital stock:		
Common, $100 par value, 2,000 shares outstanding		$ 200,000
Reserves for depreciation		30,000
Accounts payable		50,000
Universal Machinery Company—advances		30,000
Surplus:		
Balance January 1, 1932	$100,000	
Net profit for year	20,000	
	$120,000	
Dividend paid	50,000	
Balance December 31, 1932		$ 70,000
		$ 380,000

Income Account for the year 1932

	Universal Machinery Company	Universal Machinery Company of Canada, Ltd.
Net profit from operations	$47,000	$25,000
Depreciation @ 5% of buildings and equipment at January 1, 1932	20,000	5,000
	$27,000	$20,000

Miscellaneous income:		
Dividend received from Universal Machinery Company of Canada, Ltd.	$50,000	
Dividend on Universal Machinery Company stock held as an investment	3,000	
	$53,000	
	$80,000	
Provision for federal income taxes	10,000	
Net profit for year	$70,000	$20,000

(1) The Canadian dollar was quoted at 90 cents on December 31, 1932, and at par on January 1, 1932. The average rate for the year was 95 cents.
(2) The investment of the Universal Machinery Company in the real estate, plant and equipment of the Canadian company at January 1, 1932 amounted to $155,000 United States currency.
(3) Additions to the real estate and plant of the Canadian company during 1932 amounted to $30,000 Canadian currency.
(4) The question of income taxes need not be further considered.

No. 3 (15 points):

Compute the federal income tax of Simon Marks, retailer, for the calendar year 1933. His income and expenses for the year were as follows:

Sales		$91,000
Dividends received		870
Profit on sales of real estate, securities, etc.		2,000
Interest received		900
Purchases	$74,000	
Salaries paid	10,400	
Rent	3,000	
Light	1,200	
Donations	280	
Interest paid	1,650	
Advertising	1,350	
Taxes and licences	520	
Delivery expense	600	

Upon inquiry, you learn the following:

(a) The inventory of goods on hand at January 1, 1933 was $21,000, and at December 31, 1933 was $18,500.

(b) The dividends were received from the following sources:

Domestic corporations which are not exempt from the income tax	$570
Foreign corporations	300
Total	$870

The dividends declared by the domestic corporations on Mr. Marks' stock were $600. However, he received only $570. The remaining $30 was deducted and withheld by the payor corporations as the federal tax on dividends.

(c) The interest received consisted of:

Board of education, city of Chicago bonds	$212.50
Federal farm loan bonds	225.00
Foreign government bonds	212.50
Bonds containing a 2% tax-free covenant clause	250.00
Total	$900.00

(d) The salaries paid included a salary of $5,200 paid to Simon Marks.

(e) The donations consisted of the following:

Community chest	$ 50
Democratic committee	100
The Crusaders	10
Salvation Army	10
Red Cross	25
An indigent relative	25
Christmas bonus to employees	60
Total	$280

(f) The taxes and licences paid were as follows:

Personal property tax	$ 50
Retailers' licence	100
Street-improvement tax	100
Real-estate tax on residence	210
Automobile licences	20
Federal cheque tax	20
Tax on club dues	20
Total	$520

(g) The profits from sales of securities, grain, etc., were as follows:

Profit from sale of grain		$2,000
Profit from sale of unimproved real estate		2,000
Total profit		$4,000
Loss from sale of securities which were owned less than two years at time of sale:		
Foreign government bonds	$1,000	
Stock of domestic corporations	1,000	2,000
Net profit		$2,000

(h) Mr. Marks was married and living with his wife and had two dependent children under 18 years of age throughout the entire year.

No. 4 (15 points):

Charles Black & Co., a corporation, had a factory whose output was absorbed by two customers.

The president and the treasurer each signed cheques, only one signature being necessary. The president bought the raw materials and supplies. The treasurer kept the books, handled the receipts and drew the cheques. Incidentally, he was also receiving teller in one of the local banks patronized by the company.

The accounts of Charles Black & Co. had never been audited until the president demanded an audit which developed at once into an investigation.

All the paid cheques returned by the banks were on hand and available to the auditor, and the cheques received from the two customers were produced on request. After a brief examination

of the latter, inquiries revealed that the treasurer had a personal account in his own bank and another in a large bank in an adjacent city.

It was found that $65,000 of customers' cheques had not been credited to them nor entered anywhere on the books (except $10,000 mentioned below). The treasurer had endorsed the cheques for the company in blank in his own handwriting and used them himself by passing them through bank accounts other than those of the company, as evidenced by later endorsements.

There were cheques aggregating $25,000, which had been credited to customers' ledger accounts but not entered in the cashbook nor deposited in the company's bank account. These were similarly endorsed and used.

Cash sales of old machinery and scrap amounting to $1,200 had been made and entered, but the proceeds were retained by the treasurer.

A mortgage was placed on the factory for $10,000 and the company received the money in two instalments of $5,000 each. The full amount was entered in the cashbook as received and credited to mortgage account in the ledger, but only $5,000 was placed in the bank. The other $5,000 was taken by the treasurer, for which he gave his note. An entry crediting cash and charging notes receivable was made by him. Several months later he discounted at the bank a company note for $5,000 to the credit of the company, charging cash as if coming from him and crediting notes receivable. He destroyed his own note. When the company's note was due the bank charged it to the company, but no entry whatsoever was made on the books. The treasurer destroyed this note also. The president of the company knew of the mortgage but denied all knowledge of the notes.

Later another $10,000 was borrowed on the mortgage, but no entry was made on the books. The treasurer turned this money to his own uses. About a month later one customer's cheque for $10,000, as above mentioned, was credited to the mortgage account instead of being credited to the customer.

On the other hand, $30,000 in all was deposited in the bank at various dates to the credit of the company by the treasurer himself, without entry on the books.

Payments to creditors and for salaries and wages and other expenses for the past year, by quarters, aggregated as follows:

	Per cash book	Per cheque book stub	Per cheques
Accounts payable—1st quarter	$ 3,225	$ 2,525	$ 1,725
" " 2nd "	3,000	2,500	2,000
" " 3rd "	8,250	7,250	6,250
" " 4th "	4,800	4,300	3,500
	$19,275		$13,475
Cash for salaries, wages, etc.:			
" " " 1st quarter	3,100	3,500	4,100
" " " 2nd "	5,600	5,600	6,600
" " " 3rd "	1,500	2,000	2,500
" " " 4th "	2,700	4,500	5,500
	$32,175	$32,175	$32,175

All correspondence from creditors relative to short payments had been suppressed by the treasurer.

If the candidate finds any evidence of shortage in the figures next above he may consider them part of the defalcation.

Prepare a statement showing briefly the several items making up the total defalcation. Disregard interest. No journal entries are wanted.

No. 5 (12 points):

From the following balance-sheets of the R Company and other information given below prepare a statement of resources and their application in the year 1933:

BALANCE-SHEETS OF THE R COMPANY

Assets	December 31, 1932	December 31, 1933
Land and buildings	$ 450,000	$ 750,000
Machinery	200,000	400,000
Tools	40,000	80,000
Goodwill	200,000	230,000
Investments	95,000	
Inventories	400,000	375,000
Accounts receivable	175,000	250,000
Unexpired insurance	3,000	4,000
Cash	25,000	20,000
	$1,588,000	$2,109,000
Liabilities		
Capital stock	$ 800,000	$1,100,000
Bonds	350,000	500,000
Notes payable	70,000	80,000
Accounts payable	145,000	125,000
Accrued interest	7,000	11,000
Accrued taxes	4,000	6,000
Surplus	212,000	287,000
	$1,588,000	$2,109,000

During the year a dividend of 4% was declared and paid on the stock outstanding at the beginning of the year. Seven thousand dollars was provided for the depreciation of the buildings; $16,000 for machinery and $4,000 for tools. The bonds were sold at par, the stock was sold at 90 and the difference was charged to goodwill account.

No. 6 (12 points):

A machine costing $256 is estimated to have a life of four years, with a residual value of $16.

Prepare a statement showing the annual charge for depreciation according to each of the following methods: (a) straight line; (b) constant percentage of diminishing value; (c) annuity method.

Assume the rate of interest to be 10%.

No. 7 (12 points):

The H. Manufacturing Company has been losing money for several years and intends to reorganize.

From the following list of accounts as at December 31, 1933, and other information given below prepare a statement of affairs also showing the amounts that will be realized and the estimated losses on realization:

Account	Amount
Advances to employees	$ 2,657.44
Cash	4,204.67
Creditors	104,231.33
Creditors, preferred	1,716.20
Customers	200,676.93
Capital stock, common	200,000.00
Capital stock, preferred	150,000.00
Capital stock subscriptions	96,400.00
Deficit	133,893.43
Furniture and fixtures	9,197.26
Goodwill	75,000.00
Inventories	75,693.07
Notes payable	189,663.51
Notes receivable	11,462.50
Plant and machinery	33,860.49
Real estate	2,565.25

The original capital stock was $150,000 preferred and $100,000 common, which was fully paid. The subsequent authorized increase of $100,000 common stock is unpaid, except $3,600. The remaining $96,400 is due from wholly insolvent subscribers. The company has assigned $24,072.08 of its customers' accounts, worth their face value, to one of its creditors and estimates that it still has an equity in them of $2,661.81, although this fact does not appear on the books. Of the remaining customers' accounts

$46,706.00 are barred by the statute of limitations and $36,584.03 are more than doubtful. The remaining assets are estimated to be worth as follows:

Inventories	$ 9,996.42
Plant and machinery	22,088.38
Real estate	1,830.25
Furniture and fixtures	6,697.26
Notes receivable	9,823.40