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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, 1928.]

Examination in Auditing

MAY 17, 1928, 9 A. M. to 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (8 points):

Prepare an audit programme for a thorough verification of the cash balance of a corporation operating a chain of retail drug stores.

No. 2 (15 points):

In commencing an audit, on January 20, 1928, of the accounts of four brothers for the calendar year 1927, the following conditions are met:

The accounts of each estate are kept in a separate set of books, in order to preserve the privacy of the affairs of each brother. The records of all the personal estates are kept by one confidential secretary and his staff. The books of each estate have been closed as of December 31, 1927, but none of the January, 1928, transactions has been entered. All the personal estates are large and include many marketable securities. The owners of these assets are often away for several months on business or for recreation. During the year under audit, there were frequent purchases and sales of stocks and bonds. Some of the investment securities are kept in the secretary's office safe, others are kept in separate safe-deposit boxes for each estate and the rest are held by brokers. The secretary has access to all safe-deposit boxes.

Outline the procedure to be used in verifying the securities and submit the report which you would make upon this feature of the examination.

No. 3 (7 points):

Mention five important points of personal conduct to which an auditor or accountant should give particular attention on an engagement.

No. 4 (10 points):

For several years, including 1925, a public accountant had prepared statements and tax returns for the F corporation. In August, 1926, he was approached by M who, according to the newspapers, had purchased the F corporation's business. M asked him for copies of his statements previously made for the corporation, his stated intention being to use them for comparative purposes. M asserted that he had the financial records from the inception of the F corporation.

Explain fully how you would act if confronted by such a situation and tell why.

No. 5 (15 points):

A manufacturing company submits an inventory based on actual count or inspection. Outline a suitable programme for the verification of such an inventory.

No. 6 (10 points):

You are engaged to audit the books of account of the X corporation for the year ended December 31, 1927, its condensed balance-sheet, as of that date, being as follows:

Assets			*Liabilities*		
Current assets		$70,000	Current liabilities		$30,000
Fixed assets	$75,000		Capital stock	$80,000	
Less: Depreciation reserve	15,000		*Less:* In treasury	20,000	
		60,000			60,000
			Surplus		40,000
		$130,000			$130,000

A statement of the surplus account is as follows:

1927				
Jan.	1	Balance forward		$22,500
Mar.	15	Income tax, 1926	$2,500	
	16	Cash dividend (25 per cent.)	20,000	
Dec.	31	Net profit for year 1927		40,000
		Balance down	40,000	
			$62,500	$62,500

Your investigation of the item of treasury stock reveals that the company, by proper corporate action, acquired 200 shares of its own capital stock in March, 1927, immediately after declaration of dividend, paying $20,000 cash therefor, as evidenced by the entry on the books:

Treasury stock, Dr.	$20,000	
Cash, Cr.		$20,000

The laws of your state provide:

> "Every corporation shall have the power to purchase, hold, sell and transfer shares of its own capital stock; provided that no such corporation shall purchase its own shares except from the surplus of its assets over its liabilities, including capital."

Being authorized by the board of directors to make any entry you deem necessary to bring the treasury stock purchase within the requirements of the law, state what entry, if any, you would make.

NOTE:—No income tax for 1927 is to be given consideration.

No. 7 (10 points):

You are retained to audit the accounts of a fruit-packing plant for the year ended December 31, 1926. The packing season is from May 15th to September 15th.

As you are required to certify to the profits for the year 1926, as well as to the closing balance-sheet, you will have to examine the inventories at the beginning and end of the period.

You find that the company did not maintain any accurate stock records and that the costs were very largely a matter of estimate.

In this particular company, large stocks are carried over at the end of each year.

Outline your procedure in verifying the opening inventory.

No. 8 (10 points):

In 1925 the T corporation purchased heavy motors, costing $30,000, and charged them to "equipment" account. As an "electrical equipment" account was also carried on the books, the auditor questioned the distribution and was told that "electrical equipment" included only unitemized plant charges, such as wiring. The charge was allowed to stand.

Depreciation rates in effect were 15 per cent. the first year: on machinery, 10 per cent. on remaining balances thereafter; on equipment and electrical equipment 40 per cent. on remaining balances.

Under long-standing bonus contracts with managers 65 per cent. of the profits were divided among them.

Late in 1926, it was discovered that heavy motors had, prior to 1920, been charged to machinery account and the auditor was so informed.

What action should he take or recommend?

No. 9 (9 points):

A corporation finds that if it charges the usual amount of depreciation, the net profits for 1927 will not equal the dividend requirements. It decides to make no charge for depreciation in that year, as an appraisal has shown a large appreciation in fixed assets over book value and a depreciation considerably less than the reserve on the books.

The declaration of a dividend is delayed pending your advice.

What advice will you give?

No. 10 (6 points):

(a) Outline a method of handling dues for a club which has two classes of members.

Bills for dues are rendered semi-annually. A statement of income and expense and a balance-sheet are prepared monthly.

(b) Indicate the accounts which might appear on the balance-sheet relating to dues and state in what balance-sheet group each should appear.

Examination in Accounting Theory and Practice

PART I

MAY 17, 1928, 1 P. M. TO 6 P. M.

The candidate must answer the first four questions and one other question.

No. 1 (30 points):

(a) The M E F Manufacturing Company distributes burden by using man-hour departmental rates, determined at the close of each month.

Last month, the rate for department F was almost double that of the prior month and the president of the company claims that an error has been made.

The cost accountant says that he has determined the rate as usual and that his computations are correct.

You are called in to investigate and you discover that one half of the machines in the department were idle during the greater part of the period, which accounts for the increase in the burden rate.

The president expresses his opinion to you that the cost accountant is confusing "cost" with "loss."

Discuss the matter and explain, briefly, your conclusions.

(b) The plant of the Atlas Manufacturing Company is made up of six buildings, on one site, in the town of P.

Burden is distributed by using the "predetermined-machine-hour rate method."

A machine, numbered A-2-34, has a burden rate of $0.2146 per hour, on the assumption that the center should operate 2,000 hours in the current year.

Explain, as fully as possible, giving schedules, how the rate is determined, assuming that steam power is used and that light and water are purchased. (NOTE:—You may submit your answer to part (b) in the form of a diagram, if you so desire. The time devoted to problem No. 1 should not exceed one and one-half hours.)

No. 2 (23 points):

A partnership agreement provided that profits or losses should be shared in this proportion: A, five twelfths, B, one third and C, one fourth, the capital contributed originally being in this proportion.

At the end of a certain period, the books showed assets, $90,000 and these capital accounts: A, $10,000, B, $30,000 and C, $50,000.

It was decided to liquidate and in the process the following transactions were recorded:

Mar. 31—Assets	inventoried	at	$10,000	were	sold	for	$8,000
Apr. 30— "	"	"	40,000	"	"	"	19,500
June 30— "	"	"	10,000	"	"	"	7,000
Sept. 30— "	"	"	30,000	"	"	"	14,700

The amounts realized were credited, as of the dates given, in accordance with agreement.

Prepare a statement showing the entries in each partner's account and the final balances.

No. 3 (8 points):

A is a holding company. B is a wholly owned subsidiary company of A. B company gives an accommodation note to A company for $100,000 and A company discounts this note with its bank.

How should this transaction be shown on the balance-sheet of A company, on the balance-sheet of B company and on the consolidated balance-sheet of A and B companies?

No. 4 (16 points):

On January 1, 1920, the Noble Machine Company purchased a new building for $40,000. It was believed that its service life would be 20 years without scrap value, and straight-line provision for depreciation was made accordingly.

In the late spring of 1925, the Wright Appraisal Company reported that the building had a replacement value of $60,000 on a 25-year life basis.

The directors desire to set up the appraisal value on the books, as of June 30, 1925, and ask you to submit the necessary entries as of that date and also for the closing of the books on December 31, 1925 and 1926.

No. 5 (23 points):

An architect (not a member of the American Institute of Architects) became party to a contract for the construction of a building for which he had drawn the plans.

The actual construction was undertaken by a construction corporation and the agreement was that 40 per cent. of the profit of the corporation, after providing for federal tax, should be paid as compensation to the architect.

Upon completion of the contract, the books of the corporation showed:

Profit before tax (13½%) and before payment of architect's compensation	$232,401.50
Expenses included in book figures, not allowable as deductions from profits in computing tax, but proper deductions for computation of architect's proportion of profit.................	13,205.00

The architect's compensation is deductible from the corporation's taxable income.

What is the amount of the tax and what is the compensation of the architect?

Give proof of your answers.

No. 6 (23 points):

It is desired to retire a loan of $900,000 due in 20 years by the establishment of a sinking fund earning 5 per cent. per annum. No payments are to be made to the sinking fund until the end of the fourth year.

The first five annual payments would each be of the same amount. The next five would each be 50 per cent. more than those of the first five years. For the remainder of the term, they would each be double those of the first five years.

What would be the respective annual payments?

Given at 5 per cent:

	$(1+i)^n$	$s_{\overline{n}\rceil}$
4	1.2155	4.3101
5	1.2763	5.5256
6	1.3401	6.8019
7	1.4071	8.1420
11	1.7103	14.2068
12	1.7959	15.9171
16	2.1829	23.6575
17	2.2920	25.8404
20	2.6533	33.0660

Examination in Commercial Law

May 18, 1928, 9 a. m. to 12:30 p. m.

Answer no more than ten questions as directed.

Give reasons for all answers.

NEGOTIABLE INSTRUMENTS

Answer three questions.

No. 1. Is it necessary that a promissory note contain the words "for value received" or other words expressing consideration in order that the note be negotiable?

No. 2. X represents to Y that he is soliciting money for a charity and succeeds in getting Y to draw a cheque payable to X for $100. X endorses the cheque to A, an innocent third party, who has no notice of any defenses. X receives from A for the cheque $100, which X keeps. X, as a matter of fact, did not represent the charity. After the cheque has passed to A, Y learns that he has been defrauded by X, and he therefore stops payment on the cheque. The bank on which the cheque is drawn does not pay the cheque when it is presented by A. A sues Y on the cheque, and Y defends on the ground that the cheque was originally obtained from Y by fraud. Is the defense valid?

No. 3. In the preceding question assume that Y, after the transactions mentioned and before suit is filed, becomes insolvent so that it will be futile for A to try to collect anything from him. If such were the case, could A recover from the bank on which the cheque was drawn?

No. 4. A negotiable promissory note is expressed to be payable to the order of X six months after date. Through error A, the maker of the note, fails to date it "January 1, 1927," the date on which it was given. X fills in "July 31, 1926" as the date, and on January 15, 1927, endorses the note to B, who is a bona-fide purchaser of the note for value without notice that there is anything wrong with the note. B, on February 1, 1927, presents the note to A for payment. A refuses to pay. On February 15, 1927, B sues A, who defends on the ground that his obligation is not due until six months after January 1, 1927. Is the defense valid?

CONTRACTS

Answer two questions.

No. 5. August 1, 1927, A in Baltimore by letter to B in New York offers to sell to B five hundred bushels of potatoes. The price, description, terms and place of delivery are all set forth in the letter and are sufficiently definite for a contract. On August 2, 1927, the price of potatoes rises, and A wires B that he revokes his offer of August 1, 1927. A few minutes before receiving this wire B had put in the mail a letter to A properly addressed and stamped in which he accepted A's offer. A does not receive this letter from B until after B has received A's wire. Was there a contract between A and B?

No. 6. A owes B $500. There is no dispute as to the amount owed or as to A's liability to pay the $500 to B. A pays B $300, and B gives to A a receipt for the $300 in which he states that he accepts the $300 in full discharge of A's obligation to pay the $500. Later B sues A for the remaining $200. Can he recover?

No. 7. A in writing offers to sell to B three dozen hats. The description of the hats, the price of them and the terms of the proposed sale are all set forth in the offer and are all sufficiently definite for a contract. A also states in the offer as follows:

> "I agree that this offer will remain open for two weeks and that I can not revoke it until the expiration of that time."

At the end of one week A writes B that he revokes the offer. In reply B writes to A that he accepts the offer to sell as stated in A's original letter. This letter is received by A before the expiration of the two weeks. Was there a contract?

CORPORATIONS

Answer both questions.

No. 8. (a) What is a cumulative dividend?
(b) What is a de facto corporation?
(c) What is a de jure corporation?

No. 9. Has a corporation, without express statutory authority to do so, the power to purchase and hold the stock of another corporation, assuming, of course, that there is no statute expressly prohibiting the corporation from doing this?

PARTNERSHIP

Answer one question.

No. 10. Jones, Smith and Brown are partners engaged in the business of buying and selling real estate. The name of the firm is "Jones, Smith & Brown." Brown resigns and a new firm is formed composed of Jones and Smith, but the new firm continues to use as its firm name the name of "Jones, Smith & Brown." People who had been trading with the old firm were not notified of the dissolution. Six months later X, a person who had been trading with the original firm for a number of years prior to its dissolution and who did not know of its dissolution, entered into a contract with Jones on behalf of the new firm "Jones, Smith & Brown." The contract was breached by the new firm "Jones, Smith & Brown" and X was damaged. Can X hold Jones, Smith and Brown individually responsible, or can he simply hold Jones and Smith individually?

No. 11. (a) If no time is expressly or impliedly specified in the articles of partnership for the time that the partnership will last, when may the partnership be terminated?

(b) Whenever a partner retires or a new one is admitted to the firm, does that operate to dissolve the existing partnership and cause the formation of a new partnership?

FEDERAL INCOME TAX

Answer both questions.

No. 12. A buys a house in 1916 for the purpose of living in it as a home. In 1927 he sells the house for $5,000 less than it originally cost him. Can he deduct this $5,000 from his gross income in order to determine his net income for the year 1927?

No. 13. (a) How are partnerships taxed under the revenue act of 1926?

(b) Summarize the provisions of the 1926 revenue act relating to losses allowed individuals as deductions.

Examination in Accounting Theory and Practice

PART II

MAY 18, 1928, 1 P. M. TO 6 P. M.

The candidate must answer all the following questions:

No. 1 (25 points):

From the following particulars, prepare a statement showing the disposition of funds received during the year ended December 31, 1927, and statement of working capital:

A COMPANY—BALANCE-SHEETS

	Years ended Dec. 31	
Assets	1927	1926
Cash	$300,000	$170,000
Certificate of deposit	200,000	
Marketable securities	220,000	100,000
Customers' notes and accounts receivable	300,000	250,000
Inventories	160,000	100,000
Investment in affiliated company	180,000	200,000
Cash and securities in sinking fund		70,000
Deposit on account of new construction	140,000	
Plant and equipment	2,000,000	1,400,000
Goodwill		200,000
Discount on funded debt	50,000	20,000
	$3,550,000	$2,510,000

Liabilities	Years ended Dec. 31 1927	1926
Accounts payable	$200,000	$150,000
Purchase-money obligations		120,000
Interest, payroll and taxes accrued	40,000	20,000
Reserve for depreciation	600,000	400,000
Funded debt:		
First-mortgage six per cent. bonds		350,000
Serial gold notes	1,000,000	
Premium on treasury stock sold	170,000	
Capital stock	1,000,000	800,000
Earned surplus	540,000	670,000
	$3,550,000	$2,510,000

Surplus Account

Balance—January 1, 1927		$670,000
Net income for year ended December 31, 1927		200,000
Appreciation of marketable securities		70,000
		$940,000
Less:		
Dividends—Cash	$90,000	
" —Stock	90,000	
Goodwill written off	200,000	
Discount on bonds	20,000	400,000
Balance—December 31, 1927		$540,000

No. 2 (22 points):

The balance-sheet of the Tiber Manufacturing Company, Inc., as at December 31, 1926, prepared by the company, was as follows:

Assets

Current assets:		
Cash		$17,500
Notes and accounts receivable		165,000
Inventories (at lower, cost or market):		
Raw material and supplies	$80,000	
Goods in process	35,000	
Finished goods	120,000	
Goods on consignment	25,000	260,000
Total current assets		$442,500
Prepaid expenses:		
Interest and insurance		1,700
Fixed assets:		
Land	$75,000	
Buildings	325,000	
Machinery and equipment	550,000	950,000
Total		$1,394,200

Liabilities

Current liabilities:	
Notes payable	$145,000
Accounts payable	230,000
Accrued liabilities—wages and taxes	7,000
Total current liabilities	$382,000

Reserves:		
Depreciation	$220,000	
Bad debts	3,500	
For general purposes	50,000	273,500
Stockholders' equity		738,700
Total		$1,394,200

The authorized capital stock of the company, all of which is outstanding, consists of 3,000 shares of 6 per cent. cumulative preferred stock and 5,000 shares of common, all shares being of the par value of $100 each. The former is preferred both as to capital and dividends and the preferred dividends, payable June 30th and December 31st, have been paid to June 30, 1925.

Advances to officers and employees aggregate $25,000, for which notes were given. Travel advances to salesmen amount to $3,500 and the balances due from customers on open account are expected to realize $133,000. Customers' notes receivable amounting to $20,000 have been discounted.

The stated liability on notes payable includes trade acceptances $25,000 and the balance, consisting of loans from banks, is secured by the hypothecation of finished goods valued in the inventory at $70,000.

The fixed assets are stated at the appraised value of December 31, 1926, when the net book value—$500,000 (cost less depreciation)—was adjusted to the appraisal figures.

Noting these facts, you are asked to comment on the above balance-sheet making such changes in form as you consider desirable.

No. 3 (13 points):

A corporation was formed January 1, 1909.

The buildings, taken over from a predecessor company, were set up on the books of the new company at cost to that company, in one amount, and depreciation for federal income-tax purposes was based upon such value.

As of December 31, 1926, an appraisal was made of the company's plant in detail and new plant values, representing depreciated replacement values, were set up on the books as of January 1, 1927.

As the result of an earthquake in 1927, part of the walls of one of the buildings collapsed and had to be rebuilt, the loss sustained not being covered by insurance.

State how you would proceed to estimate (1) the amount of the book loss to be recorded and (2) the amount of loss to be claimed on the company's federal income-tax return for 1927.

If the loss to be claimed on the tax return is $4,480, and depreciation on buildings has been taken at the rate of 2 per cent. per annum, what was the indicated cost at January 1, 1909, of the walls destroyed?

No. 4 (40 points):

X corporation desired control of corporation B and to that end began buying its common stock wherever it could be found. As a result, the price demanded for the stock advanced so high, that in June, 1927, the X corporation discontinued this plan of purchase. In the meantime, it had bought 20,000 shares at prices ranging from $20 to $50, averaging $36. In addition, it had acquired 12,000 shares by an exchange, from its own treasury stock, of one half share of X preferred and one share of X common for each share of B stock.

In November, 1927, by direct negotiation, the directors of corporation B (who controlled 60 per cent. of its stock) agreed to sell to X corporation all its assets, except cash, at December 31, 1927, on the following basis:

(1) For sound value of fixed assets, as determined by appraisal, corporation B is to be paid 10 per cent. in cash and 90 per cent. in preferred stock of X corporation. (At par, $100 per share.)

(2) For current assets, at 90 per cent. of book value, corporation B is to receive cash, less the amount of current liabilities, which are to be assumed by X corporation.

(3) B corporation is to receive common stock of X corporation (at par of $50 per share) as payment for goodwill, including all intangibles, the amount to be determined by capitalizing at 20 per cent. the average net earnings for the 5 years 1923 to 1927, inclusive, in excess of $2 per share on 100,000 shares of outstanding stock.

In determining such net profits, adjustments are to be made to bring such items as depreciation and capitalization of fixed-asset charges in the several years, to the basis to be determined by a retrospective appraisal. Administrative salaries, also, are to be adjusted to $24,000 for each year in which greater amounts were actually paid.

An audit, before the above settlement adjustments, discloses the following facts:

	Net profits	Administrative salaries	Depreciation charges	Net addition to fixed asset accounts
1923	$81,000	$15,000	$198,000	$40,000
1924	192,400	30,000	207,000	12,000
1925	178,000	21,000	214,000	202,000
1926	313,000	70,000	242,000	300,000
1927	297,000	62,500	251,000	84,200

The audit also discloses that profits had been augmented by gains in sales of fixed assets over depreciated values as follows:

1925	$14,100
1926	16,800
1927	1,300

The appraisal report shows the following:

	Proper additions to fixed assets	True depreciation
1923	$62,000	$140,000
1924	18,000	140,400
1925	260,000	146,000
1926	297,000	157,200
1927	91,800	165,000
Reproduction value of fixed assets, December 31, 1927		$6,200,000
Depreciation		2,800,000
Sound value		$3,400,000

The true depreciation shown by appraisal is presumed to be sufficient to absorb all cost of an asset during the years of its use, so there should be neither profit nor loss at time of sale or scrapping.

The condensed balance-sheet of B corporation, December 31, 1927, is as follows:

Assets

Cash		$81,000
Receivables		56,000
Inventories		574,000
Prepaid expenses		9,000
Mortgage sinking fund		400,000
Plant	$4,000,000	
Less: Depreciation	2,400,000	1,600,000
Organization expense		80,000
Patents and trademarks		1,000,000
		$3,800,000

Liabilities

Notes and accounts payable	$200,000
Long-term notes	100,000
Mortgage on plant, due January 1, 1928	1,000,000
Common stock—100,000 shares, no par value	2,000,000
Surplus	500,000
	$3,800,000

X corporation has sufficient shares of capital stock, authorized but unissued, to comply with the settlement terms, but to meet the cash requirements, it issues 6 per cent. gold notes amounting to $1,000,000, which are taken by a syndicate for cash at 96 per cent. net.

After the deal is consummated, corporation B immediately liquidates all liabilities, including costs of settlement and liquidation amounting to $20,000, and distributes all assets in kind to stockholders.

From the foregoing, you are required to prepare

(a) a tabulated statement showing the determination of amounts needed for settlement purposes,

(b) all journal entries to give effect to above transactions on the books of corporation B,

(c) all journal entries to give effect to above transactions on the books of X corporation.