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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, November 15 and 16, 1928.]

Examination in Auditing

NOVEMBER 15, 1928, 9 A. M. TO 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (5 points):

Name and define three classes of proprietorship, and state how the equity of each class is shown on the balance-sheet.

No. 2 (17 points):

You are called upon to install an accounting system for a manufacturing concern. State in detail the system you would suggest for

(a) Cash
(b) Purchases
(c) Payrolls

No. 3 (12 points):

Engaged by a small corporation to prepare its federal income-tax return, you are given the balance-sheets as of the beginning and end of the year, a profit-and-loss statement for the year and free access to the books. The accounts are assumed to be correct.

State what steps you would take to insure the accuracy of the figures for the schedules and items of the return, and how you would make up the required working papers for future inspection by treasury agents.

No. 4 (8 points):

Name eight points the auditor must ascertain in making a balance-sheet audit.

No. 5 (12 points):

Auditing a manufacturing concern for the year 1927, you find, on the balance-sheet, the item "Cost of patent, $4,900." Turning to the account in the ledger, you find the following items debited:

1925	Legal expenses defending validity of our patent No. —	$2,000
1926	Legal expense prosecuting infringement of our patent No. —	1,000
1927	Legal expense prosecuting same	500
	Improvements made on machine covered by our patent No. —	1,400
		$4,900

There are no credits to the account and no amortization reserve has been set up on the books.

Upon inquiry, you learn that the patent covering the machine in question was issued in 1919 and that no additional patent has been sought for the improvements made to the machine. The expenditures for fees, experiments, etc., for the invention, amounting to $510, were charged to current expense in 1919.

(a) State what criticism of the above account you have to offer, (b) prepare the journal entries necessary to correct it, (c) show the book value of the patent as of December 31, 1927, and (d) state the advantages or disadvantages to the concern in thus re-casting the patent account.

No. 6 (10 points):

State three methods of accounting for the profits made on sales on the instalment plan and what reserves you would provide in each instance.

No. 7 (8 points):

Engaged to audit the records of a small retailer, you find there is but one book kept, viz.: a columnar book of some fifty-odd columns containing all the accounts—real, personal and nominal—

usually found in an ordinary ledger. The book is kept on the double-entry plan.

State the first steps you would take to assure yourself of the general accuracy of the bookkeeping *before* proceeding to verify the accounts themselves.

No. 8 (10 points):

In examining the books of a corporation having subsidiaries you find that, in addition to inter-company accounts receivable and payable, there are notes receivable from, and payable to, an affiliated company the accounts of which are not being examined. On the consolidated balance-sheet only the excess of the notes receivable over the notes payable is shown. Is this procedure permissible? State the reasons for your answer.

No. 9 (8 points):

The capital stock of the A company of California is wholly owned by the B company of New York. You are engaged each year to examine the accounts of the former company and to render a report thereon to the New York company. In verifying these accounts for the year 1927, you discover that on January 3, 1927, the manager of the A company withdrew $50,000 from its funds and it was charged to his personal account on the books; that the amount was repaid in full on December 27, 1927; and that on January 3, 1928, the same amount was again withdrawn and charged to his personal account as before.

What would you say in your report to B company regarding these transactions?

No. 10 (10 points):

The X department store owns and occupies its building. In 1923, the president of the company executed a lease for a portion of the building without the knowledge of the other officers or directors. No rent was collected from the tenant by the company. In 1927, the tenant, threatened with bankruptcy, offered a settlement to all his creditors including his landlord, the X department store.

The accounts of the department store had been audited annually by a public accountant. Should he have discovered the omission of this lease and accrued rents? If so, how?

Examination in Accounting Theory and Practice

PART I

NOVEMBER 15, 1928, 1 P. M. TO 6 P. M.

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

No. 1 (23 points):

From the data following, prepare profit-and-loss account for the year ended December 31, 1927. In addition thereto, show the average gross profit per pound, the selling expense per pound and the average operating profit per pound to the nearest cent.

	Pounds	Amount
Sales	2,963,915	$988,114
Raw material consumed	3,342,730	561,715
Inventory—finished goods—Jan. 1, 1927	285,588	80,894
Manufacturing expenses		383,508
Selling expenses		34,080
Waste recovery		18,694

The closing inventory of finished goods was shown as 271,753 pounds, valued at the cost of goods manufactured during the year.

No. 2 (20 points):

Albert Jones died on September 10, 1928. From the data following, found among his private papers, and from facts ascertained from other sources (also given), show how these items and any others indicated should be set forth in the accounts of the executor, distinguishing between the corpus and income of the estate.

Bonds owned	Cost	Market Sept. 10, 1928
$10,000 American Telephone and Telegraph Co. Sinking fund 5's. of 1960; interest dates, Jan. 1st and July 1st	$100	$105⅛
5,000 Anaconda Copper Mining Co. 6's. of 1953; interest dates, Feb. 1st and Aug. 1st	97	105
5,000 Anaconda Copper Mining Co. 7% convertible debentures; interest dates, Feb. 1st and Aug. 1st	95	133¼
10,000 Kansas City Southern Refunding and Improvement 5's. of 1950; interest dates, Jan. 1st and July 1st	100	99¾

The deceased was president and sixty per cent. owner of the capital stock of the Crow Hollow Mills, Inc., which had, on September 1, 1928, declared a dividend of ten per cent. payable September 20, 1928, to stockholders of record at September 8, 1928.

The condensed balance-sheet of the company, as at August 31, 1928, and summary of earnings for five years to June 30, 1928, are as follows:

Balance-sheet

Plant and machinery	$100,000
Patents	50,000
Current assets	75,000
	$225,000
Capital stock—1,000 shares, par value $100 each	$100,000
Accounts payable	25,000
Surplus	100,000
	$225,000

Summary of earnings

Year ended June 30th	Sales	Cost	Profit before federal taxes
1928	$265,000	$170,000	$95,000
1927	250,000	165,000	85,000
1926	240,000	150,000	90,000
1925	225,000	140,000	85,000
1924	200,000	125,000	75,000

Jones' account with the bank, according to his cheque book, showed a balance of $1,978.43. The executor, notifying the bank of Jones' death and his appointment on September 11th, received a statement showing a balance of $2,782.19.

The executor reconciled the account as follows:

Balance, as per bank		$2,782.19
Cheques outstanding:		
Smith & Co. (tailors)	$125.00	
Collector of internal revenue (3rd quarterly instalment of tax on 1927 income)	328.76	
Black & White, Inc. (Rent of apartment for September)	350.00	803.76
		$1,978.43

A cheque for $397.00 to John Brown had been paid by the bank on September 10, 1928.

No. 3 (30 points):

On January 1, 1925, the A company acquired 90 per cent. of the capital stock of the B company at a cost of $800,000. At this date, B company held 80 per cent. of the capital stock of the C company. This interest had been acquired on January 1, 1922.

During the period from January 1, 1922, to December 31, 1924, the profits from operations and the dividends paid were as follows:

	B Co.	C Co.
Profits from operations	$200,000	$35,000
Dividends paid	180,000	75,000

Companies A and B carry the investments at original cost and have not taken up the profits nor losses of the subsidiaries but have credited income with dividends received.

From the following statements, transcribed from the books of the several companies, prepare a consolidated balance-sheet as at December 31, 1927.

Balance-sheets—December 31, 1927

Assets	A	B	C
Cash	$90,000	$60,000	$20,000
Accounts receivable	700,000	340,000	100,000
Inventories	400,000	200,000	75,000
Investment in B company	800,000		
" " C "		250,000	
Prepaid expenses	10,000	10,000	5,000
Fixed assets, less depreciation	1,700,000	640,000	200,000
	$3,700,000	$1,500,000	$400,000

Liabilities	A	B	C
Notes payable	$400,000	$120,000	$100,000
Accounts payable	300,000	80,000	120,000
Funded debt	1,000,000	500,000	
Capital stock	1,500,000	600,000	250,000
Surplus	500,000	200,000	70,000*
	$3,700,000	$1,500,000	$400,000

*Deficit.

Surplus accounts

	A	B	C
Balances—January 1, 1925	$300,000	$150,000	$20,000
1925:			
Profit from operations	175,000	80,000	40,000
Dividends received	54,000	20,000	
	$529,000	$250,000	$60,000
Dividends paid	225,000	60,000	25,000
	$304,000	$190,000	$35,000
1926:			
Profit from operations	$225,000	$20,000	$20,000*
Dividends received	40,500		
	$569,500	$210,000	$15,000
Dividends paid	225,000	45,000	
	$344,500	$165,000	$15,000

1927:	A	B	C
Profit from operations	$299,500	$125,000	$85,000*
Dividends received	81,000		
	$725,000	$290,000	$70,000*
Dividends paid	225,000	90,000	
Balances—December 31, 1927	$500,000	$200,000	$70,000†

* Loss. † Deficit.

No. 4 (27 points):

Smith and Jones are engaged, as individuals, in the same kind of business. They propose to amalgamate and form a corporation.

Smith owns buildings and machinery having a book value of $100,000, now appraised at $200,000, and net other assets having a book value of $50,000. Jones owns buildings and machinery having a book value of $200,000, now appraised at $300,000, and net other assets having a book value of $150,000.

It is agreed that "net other assets," in each case, are worth their book values and shall be transferred to the books of the corporation at such values. It is further agreed that the buildings and machinery shall be transferred to the books of the corporation at book values and that 5,000 shares of capital stock, par value $100, shall be issued to the property owners.

Jones proposes that the 5,000 shares be divided pro rata to the total net assets of each individual as shown by the books but Smith, because of the lower book value of his buildings and machinery, claims that the net assets of each individual should first be adjusted by a redistribution of the total book values of buildings and machinery pro rata to the appraisals and that the capital stock should be divided on the basis of the new total net assets so found.

You are called upon to adjudicate. Show how many shares Smith and Jones would each receive under the two proposed plans; also show how many shares you would apportion to each, giving reasons for your decision.

No. 5 (27 points):

On a certain date, Mr. Mann borrowed $15,000. As he expects to inherit $5,000 three years from this date, he wishes to reduce the loan by $10,000 in the three years by making equal monthly payments, including interest at the rate of one half of one per cent. per month.

What would be the amount of the monthly payment?

Given	v^{36}	.8356449
	$(1+i)^{36}$	1.1966805

Examination in Commercial Law

NOVEMBER 16, 1928, 9 A. M. TO 12:30 P. M.

Answer no more than ten questions as directed.

Give reasons for all answers.

(Each question counts 10 points.)

GROUP I

The candidate must answer all the following questions:

No. 1. Give the essential elements of a contract and define or explain each element.

No. 2. Detroit, Michigan, October 2, 1928.

Thirty days after date I promise to pay to the order of John A. Miller, five hundred and 00/100 dollars at the Second National Bank & Trust Co.

GEORGE M. CHAPMAN.

Give the circumstances in which each of the following endorsements might have been made on the above note:

(a) GEORGE M. CHAPMAN.

(b) Pay to the order of Lester C. Mayer.
GEORGE M. CHAPMAN.

(c) Pay Lester C. Mayer only.
GEORGE M. CHAPMAN.

(d) Pay Industrial Savings Bank for deposit.
GEORGE M. CHAPMAN.

No. 3. A client of yours leases a plot of land for a term of 21 years with a right to renew the lease for a further term of 21 years. Your client erects a building on his leased land. The building has an estimated useful life of 35 years. The lease provides that upon the termination thereof the building shall become the property of the lessor. Under the federal income-tax law what yearly deduction, if any, could you take to cover the cost of the building to your client?

No. 4. Distinguish between a partnership, a joint stock association and a corporation.

No. 5. Best made a promissory note jointly with Kelly for Kelly's accommodation. Kelly altered the note into the note of a corporation, in which both were officers, forging other signatures and causing Best's signature to appear as that of a personal endorser of the note. The X bank, a holder, in due course, sued Best personally upon this endorsement. Could it recover?

GROUP II

The candidate must answer five of the following questions:

No. 6. Jones lent Smith $50. At the time Jones stated that he owed Fisher $50 which he had promised to pay the next day. Smith in consideration of the loan promised Jones that he would pay the $50 to Fisher the next day, which, however, he failed to do. Fisher sued Smith on Smith's promise to Jones. Could he recover?

No. 7. A owes B $10,000. B takes out a policy of $10,000 insuring the life of A. Subsequently A pays the loan in full but B continues the policy. Is it valid?

No. 8. What is a bill of sale?

No. 9. In what circumstances is it necessary for a holder to present a bill of exchange for acceptance?

No. 10. Are dividends on stock of corporations taxable under the federal income-tax law when received (a) by an individual, (b) by a corporation?

No. 11. X, stockbroker, is insolvent but refuses to make an assignment for the benefit of his creditors, or to take any other action. Is there any way by which his creditors can bring about a distribution of X's assets pro rata between them?

No. 12. You enter into an agreement with the Y corporation to purchase 100 shares of its preferred stock at its par value of $100. The Y corporation agrees, upon receiving payment to issue to you the 100 shares of preferred stock and 10 shares of its fully paid non-assessable common stock of the par value of $10. Upon payment you receive the stock, the common stock having printed across its face the words "Fully paid and non-assessable". Subsequently the Y corporation becomes insolvent and its trustee in bankruptcy sues you to recover $100, the par value of the common stock. Can he recover?

No. 13. A held the note of B for $300 due August 15, 1928. On July 5, 1928, A accepted from B $275 in full payment of B's note. Subsequently in August A sought to collect a balance of $25 from B. Would he succeed?

Examination in Accounting Theory and Practice

PART II

NOVEMBER 16, 1928, 1 P. M. TO 6 P. M.

The candidate must answer the first three questions and two other questions.

No. 1 (25 points):

A company, engaged in the manufacture of piece goods, had no cost system. Its sales were made on the basis of estimated costs, adding 15 per cent. to estimated direct cost to cover overhead, then adding to the total so estimated a profit equal to 12 per cent. of the selling price.

At the end of the year 1927, the trial balance was as follows:

Buildings	$276,000	
Machinery	310,000	
Spools and other similar items	33,000	
Accounts receivable	110,000	
Accounts payable		$27,000
Reserves for depreciation to		
Jan. 1, 1927—Buildings		36,000
Machinery		71,000
Sales		2,013,000
Inventory—January 1, 1927	157,000	
Purchases—raw material	1,200,000	
Labor—direct	480,000	
" foremen, etc.	213,000	

Office payroll	$76,000	
Factory expense	280,000	
Office and administration expenses	113,000	
Capital stock		$1,000,000
Cash in bank	18,000	
Surplus—January 1, 1927		119,000
	$3,266,000	$3,266,000

An estimated cost, which may be taken as representative of all the estimated costs, was as follows:

Cost per yard:	
Raw material	$ .89
Weaving—piece-work	.38
Winding, warping, etc.	.03
Foremen and supervision	.10
	$1.40
Factory and office overhead—15% of $1.40	.21
	$1.61
Profit—12% of $1.83	.22
Selling price per yard	$1.83

Inventories were principally of raw material and for the present purpose may be considered as consisting entirely of raw material at cost. The inventory at December 31, 1927, was valued at $376,000.

The rate of depreciation on buildings was 2 per cent. and on machinery, 7½ per cent.; spools, etc., were not depreciated; replacements were charged to operations (factory expense).

Before the books were closed, it was realized that a heavy loss had been sustained. Suggestions were made—a defalcation, material stolen, etc.

What was the amount of the loss and to what do you ascribe it? Indicate briefly what is needed to prevent a repetition of such conditions.

No. 2 (18 points):

On December 31, 1927, the ledger balances of Smith, Brown and Jones—a partnership, each member having a one-third interest therein—appeared as follows:

Cash	$9,500	
Receivables	98,500	
Reserve for bad accounts		$3,000
Payables		38,500
Loan from Jones		4,500

Salary due Smith		$3,000
Capital:		
Smith		25,000
Brown		14,000
Jones		20,000
	$108,000	$108,000

At this date the firm decided to liquidate and a trustee was appointed to wind up its affairs.

The following represents the results of the trustee's activities:

Particulars	1st period	2nd period	3rd period
Cash collected from customers	$56,000	$18,000	$17,500
Liabilities paid in full settlement	19,200	19,000	
Trustee's expenses and salary	2,200	1,400	2,000
Cash paid to partners	8,000	9,900	Remainder

Prepare the necessary entries to wind up the partnership, and also prepare a statement setting forth the proper distribution (in your opinion) of the amounts paid to each partner at the end of each period and showing the final result.

No. 3 (27 points):

Commencing an audit, during February, 1928, of the books of account of the A B C Manufacturing Co. for the year 1927, the balance-sheets following, prepared by the bookkeeper, were presented to you:

A B C MANUFACTURING COMPANY
BALANCE-SHEETS

Assets	December 31, 1927	December 31, 1926
Land	$40,000	$40,000
Buildings	225,000	175,000
Machinery and equipment	112,000	100,000
Tools	13,500	12,000
Patents	48,000	50,000
Unamortized bond discount	4,750	
Prepaid operating services and supplies on hand	6,250	7,500
Marketable securities		25,000
Cash	52,000	35,000
Accounts receivable	160,000	150,000
Raw materials	70,000	60,000
Goods in process of manufacture	30,000	35,000
Finished goods	100,000	110,000
Totals	$861,500	$799,500

Liabilities		
Bank loans	$10,000	$40,000
Notes payable	5,000	10,000
Accounts payable	62,000	70,000
Bonds	100,000	
Reserves:		
For depreciation of building	21,500	17,500
" " " machinery	48,800	44,500
" bad accounts	4,200	3,000
Capital stock	500,000	500,000
Surplus	110,000	114,500
Totals	$861,500	$799,500

In the course of the audit, it was ascertained that

(a) Additions to buildings, actually costing $35,000, were set up on the books at $50,000, based upon unaccepted bids by outside contractors.

(b) Machinery, costing $10,000, was sold for $3,000. The accrued depreciation on these machines amounted to $5,800 and the loss was charged against surplus.

(c) The bonds were issued on July 1, 1927, at 95. They mature in ten years and interest at six per cent. is payable semi-annually.

(d) Tools, costing $4,000, were acquired during the year and the account was adjusted to a fair value, December 31, 1927.

(e) The marketable securities were sold during the year for $32,000.

(f) Four quarterly dividends of one and one half per cent. were paid during the year.

(g) Depreciation of buildings at two per cent. was computed on $175,000 for six months and on $225,000 for the other six months.

Relative to the foregoing, prepare surplus account showing result for the year after making any adjustments you think necessary; also prepare statement showing the changes in the accounts resulting from adjustments of surplus and reserves and show the working capital at December 31, 1927.

No. 4 (15 points):

The X Y Z Light & Power Co. has an operating contract with the trustees of a bond issue, under the terms of which it must expend seven per cent. of its gross operating revenue for maintenance. Any portion of the seven per cent. not so expended must be deposited with the trustees.

Under the terms of the same contract, the company must set aside annually a reserve of four per cent. of its gross operating revenue for depreciation.

A certain built-in production unit has fallen below a profitable degree of efficiency and must be either rebuilt or replaced by a new unit.

It is decided to re-build which involves three steps, viz.:—(1) tearing down, (2) repairing certain parts, (3) re-erecting. Tearing down is done at the cost of labor only. Repairing parts requires the purchase of necessary material and entails cost of labor. Re-erecting involves principally cost of labor and incidental material.

(a) Is any part of the cost involved in the above process chargeable to maintenance or maintenance reserve? If so, designate what part and explain why.

(b) Is any part of the cost involved chargeable to depreciation reserve? If so, what part and why?

(c) Is labor cost a proper charge to depreciation reserve?

(d) Does the expenditure of money for labor retard the progress of depreciation or is that function performed only by material?

No. 5 (15 points):

The Plebe Machine Company operates under a licence from the Omnia Corporation, the owner of certain patents. In terms of the licence agreement the company agrees to pay the corporation a royalty of five per cent. of the net sales' price of all machines sold each year during the continuance of the licence. Royalty settlements on the five per cent. basis are to be made quarterly—March 31st, June 30th, September 30th and December 31st, and it is agreed that a minimum royalty of $120,000 shall be payable for each of the calendar years covered by the licence.

During the half year ended June 30, 1928, the net sales aggregated $700,000 and royalty amounting to $20,000 was paid thereon, i. e. royalty for the March quarter. The company's business is seasonal and it is claimed by the management that royalty for the calendar year, calculated on the agreed-upon basis of five per cent. of the net sales, will at least equal the stipulated minimum of $120,000.

The Plebe Company's fiscal year ends on June 30th.

State what amount you would show in the balance-sheet as the liability for royalty at the date named. Give reasons for your answer.

No. 6 (15 points):

The following are the comparative profit-and-loss accounts of the Deka Company for the two years ended December 31, 1926, and December 31, 1927, respectively:

	Year ended December 31, 1926	1927	Increase
Net sales	$1,000,000	$1,250,000	$250,000
Cost of sales	800,000	975,000	175,000
Gross profit	$200,000	$275,000	$75,000
Selling expenses	$70,000	$75,000	$5,000
General and administrative expenses	40,000	45,000	5,000
Total expenses	$110,000	$120,000	$10,000
Net profit on sales	$90,000	$155,000	$65,000
Other income:			
Interest on notes receivable	$5,000	$7,000	$2,000
Gross income	$95,000	$162,000	$67,000
Deductions from income:			
Interest on notes payable	6,000	10,000	4,000
Net income	$89,000	$152,000	$63,000

Prepare a statement accounting for the increased net income, showing the amounts due to the variation in the volume and selling prices respectively, assuming that the cost of goods was the same in both years.