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 19 and 20, 1927.]

Examination in Auditing

MAY 19, 1927, 9 A. M. TO 12 : 30 P. M.

The candidate must answer all the following questions:

No. 1 (10 points):

Describe briefly a cash audit. What is the purpose of a cash audit and what are its limitations?

No. 2 (5 points):

Define briefly and give examples of:

(a) Current assets.
(b) Current liabilities.
(c) Fixed assets.
(d) Intangible assets.

No. 3 (10 points):

What means may be used for verifying the correctness of the following items on the books of a business concern?

(a) Bank balances.
(b) Notes receivable which have been sent to bank for collection.
(c) Securities which have been pledged as collateral for loans.
(d) Indebtedness for money borrowed from banks.
(e) Indebtedness on notes payable which have been sold through note brokers, the present holders being unknown to the makers.

No. 4 (15 points):

Prepare a list of all important matters with reference to the item of inventories which require attention in making a balance-sheet audit.

No. 5 (10 points):

Why is it essential that any hypothecation of assets, or any liens existing thereon, be disclosed in a balance-sheet? Indicate the steps you would take to ascertain whether or not any part of the inventory of a manufacturer has been pledged to secure loans or advances.

No. 6 (10 points):

Among the accounts receivable of the Mississippi Company, which aggregate approximately $1,000,000, you find the following:

Account of $50,000 for sales during the previous month to the Jonesboro' Dry Goods Company, 75 per cent. of whose capital stock is owned by the Mississippi Company. Sales to this company are settled promptly in 30 days.

Account of $130,000 representing principally advances to the Memphis Metal Company (95 per cent. of whose capital stock is owned by the Mississippi Company) to enable it to make additions to its plant. A considerable part of the output of the Memphis Company is sold to the Mississippi Company at prices advantageous to the latter for use in its manufacturing operations.

Account of $25,000 for advances to the Bluestone Sales Company, all of whose capital stock is owned by the Mississippi Company, but which has a bonded debt of $100,000 to others than the Mississippi Company. The advances were made principally to enable the Bluestone Company to continue in business in spite of losses sustained for several years past.

Account of $28,000 for advances to the president of the company who expects to pay it off during the next two years out of the percentage of the company's profits which is payable to him (if earned) under contract.

What examination, if any, other than that which you would make of ordinary customers' accounts, would you deem desirable or necessary in the case of each of the foregoing accounts? What treatment would you give these accounts in stating the balance-sheet of the Mississippi Company, (a) if it be a consolidated balance-sheet, or (b) if it be a non-consolidated balance-sheet?

No. 7 (10 points):

State several reasons for the compilation of "audit papers" and, without naming each paper, describe what they should comprise.

No. 8 (10 points):

You have been retained by the executors of a recently deceased member of a firm, which operated a silk-manufacturing business, to determine the fair value of his interest in the firm. What matters, if any, would you take into consideration other than those included in the usual periodical audit of the firm's accounts? Describe your procedure with respect to any such special questions.

No. 9 (10 points):

In making a detailed audit, describe how you would satisfy yourself that the sales had been properly accounted for in three of the following five cases:

(a) An automobile manufacturer.
(b) A bituminous coal operator.
(c) A manufacturer of heavy machine tools.
(d) A silk-dress-goods manufacturer.
(e) A building contractor.

No. 10 (10 points):

May a certificate of a balance-sheet be qualified without necessarily reflecting on the validity of the balance-sheet? If in your opinion such may be the case, state the conditions and write two certificates as illustrations.

Examination in Accounting Theory and Practice

PART I

MAY 19, 1927, 1 P. M. TO 6 P. M.

The candidate must answer questions 1 or 2, 3 or 4 *and* 5 or 6.

No. 1 (47 points):

The Arlington Silk Mills incorporated a selling company in France, as of January 1, 1926, to take over the assets and liabilities of their Paris office at that date, which were as follows:

Assets

Cash	Fcs. 134,000
Accounts receivable	680,000
Merchandise at invoice price, plus freight charges, etc.	1,050,000
Furniture and fixtures	40,000
	Fcs. 1,904,000

Liabilities

Accounts payable	Fcs. 23,800
Arlington Silk Mills—current account	1,780,200
Capital stock	100,000
	Fcs. 1,904,000

The exchange rate at January 1, 1926, was 3.70 cents to the franc. During the year, merchandise costing $160,000 was shipped by the Arlington Silk Mills and billed at 10% above cost, and remittances amounting to 5,000,000 francs were made by the French company, the details being as follows:

Merchandise invoiced		*Remittances*	
1/16	$30,000 @ .0373	2/20	Fcs. 500,000 @ .0356
3/27	20,000 " .0342	6/12	1,000,000 " .0287
5/ 6	50,000 " .0324	7/10	800,000 " .0254
8/14	40,000 " .0275	8/28	1,000,000 " .0284
10/16	36,000 " .0286	11/27	700,000 " .0360
		12/12	1,000,000 " .0379
	$176,000		Fcs. 5,000,000

The trial balance of the French company at December 31, 1926, forwarded to the American company, was as follows:

Sales		Fcs. 7,730,000.00
Merchandise purchased	Fcs. 5,645,581.46	
Merchandise inventory	1,050,000.00	
Freight charges	580,000.00	
Warehouse charges	213,000.00	
Salaries	474,000.00	
General expenses	306,000.00	
Selling expenses	117,000.00	
Accounts receivable	1,610,000.00	
Cash	284,000.00	
Furniture and fixtures	50,000.00	
Accounts payable		73,800.00
Arlington Silk Mills		2,425,781.46
Capital stock		100,000.00
	Fcs. 10,329,581.46	Fcs. 10,329,581.46

The inventory at the end of the year amounted to 1,412,000 francs, which included freight charges, etc., of 140,000 francs, the exchange rate at that date being 3.90 cents to the franc.

Prepare a balance-sheet and profit-and-loss account, in dollars, for consolidation with the accounts of the American company and submit the journal entries necessary for the purpose on the books of the company.

No. 2 (47 points):

The Kroy Manufacturing Company acquired all the assets of the Pioneer Development Company as set forth in the accompanying balance-sheet, as at December 31, 1925, and thereafter operated the plant as a branch.

VENDOR COMPANY
Balance-sheet—as at December 31, 1925

Assets

Current assets:		
Cash		$79,592.81
Customers' notes and accounts receivable—		
Notes	$153,460.23	
Accounts receivable	495,816.44	
		649,276.67
Inventories at cost or market (the lower)—		
Raw materials and supplies	$173,651.83	
Manufactured goods and goods in process	393,598.17	
		567,250.00
Total current assets		$1,296,119.48
Prepaid expenses:		
Insurance, interest and taxes		$15,876.29
Fixed assets:		
Land	$123,978.15	
Buildings	571,836.32	
Machinery and equipment	929,117.19	
Office furniture and fixtures	17,824.01	
		1,642,755.67
Patents (amortized value)		500,000.00
Goodwill		750,000.00
		$4,204,751.44

Liabilities

Current liabilities:		
Notes payable—banks and brokers		$175,000.00
Accounts payable—trade creditors		214,014.32
Accrued liabilities:		
Interest, state and local taxes		25,648.19
Wages		3,519.26
Provision for federal taxes:		
Year 1925		47,829.56
Prior years		83,012.34
Total current liabilities		$549,023.67
Funded debt:		
First mortgage 6% bonds, maturing April 30, 1927		600,000.00
Reserves:		
Depreciation	$221,834.65	
Bad debts	10,154.89	
Decline in market of manufactured product	35,000.00	
General reserve	75,000.00	
		341,989.54

Capital stock issued:	
Preferred—10,000 shares, 6% cumulative	$1,000,000.00
Common—217,500 shares, no par value, declared value	1,087,500.00
Capital surplus	268,919.05
Earned surplus	357,319.18
	$4,204,751.44

The consideration agreed upon was as follows:

(1) Cash to retire the preferred stock at a premium of 10%;
(2) The assumption of all liabilities except federal taxes for the years prior to 1925;
(3) Payment in cash equal to $2.50 per share on the common stock;
(4) The issuance of one share of the Kroy Manufacturing Company's common stock, par value $100, for every fifteen shares of the vendor company.
(The market value of the Kroy Manufacturing Company's common stock was $125.)

The Development Company was liquidated forthwith and a complete distribution made to the stockholders. The expenses of liquidation amounted to $6,162.66 and the federal taxes for the period prior to 1925 were assessed and paid at the amount provided therefor in the balance-sheet.

Prepare journal entries to record the transactions on the books of both the vendor and purchasing companies and close the accounts of the former, showing particularly the account with the Kroy Company, the stockholders' and cash accounts.

No. 3 (17 points):

The proprietor of a business receives from the bookkeeper a statement of net sales, profits and percentages of profits of five departments for two half-yearly periods.

He notices that each of the five departments shows a decreased percentage of profit for the second half-year, in face of the fact that there is an increase in total sales and the total profit for the latter period is greater than that for the former.

With the idea that something might possibly be wrong, he asks you to review the figures and to give reasons for the apparent inconsistency.

Prepare your explanation in the form of a report from the statement presented, which is as follows:

	First half-year		
Department	Sales	Net Profit	Percentage of profit
A	$8,750	$962.50	11%
B	19,800	1,485.00	7½
C	21,250	1,062.50	5
D	8,250	1,237.50	15
E	10,920	1,337.70	12¼
	$68,970	$6,085.20	

Department	Second half-year Sales	Net profit	Percentage of profit
A....................	$19,120	$1,912.00	10%
B....................	10,870	760.90	7
C....................	8,080	363.60	4½
D....................	18,940	1,799.30	9½
E....................	15,830	1,899.60	12
	$72,840	$6,735.40	

No. 4 (17 points):

You are requested to make a balance-sheet examination as at December 31, 1926, of the A Company, engaged in the manufacture of machinery.

During your examination, you are informed that the inventory has been valued at cost, as reflected by detailed job-cost records on file. A study of the job-cost system, under which the inventory has been valued, indicates that factory burden has been absorbed in costs as a percentage of direct labor. The company's operating accounts tend to show that a considerable balance of unabsorbed factory burden has accumulated during the year, in spite of the fact that the plant was operated to capacity during the entire calendar year 1926.

(1) What are your conclusions regarding inventory valuation based upon the information cited above?

(2) What adjustment, if any, would you make in the total valuation of the inventory at December 31, 1926?

(3) If an adjustment in inventory valuation were necessary, how would you make it?

No. 5 (36 points):

On January 1, 1927, a corporation floated a bond issue of $300,000 to be retired serially over a period of eight years as follows:

Dec. 31, 1927.......	$10,000	Dec. 31, 1931..........	$30,000
" " 1928.......	15,000	" " 1932..........	35,000
" " 1929.......	20,000	" " 1933..........	40,000
" " 1930.......	25,000	" " 1934..........	125,000

Discount and expense of issuing the bonds amounted to $33,000.

Draft a schedule, showing how much of such bond discount and interest you would claim as a deduction from gross income, for federal income-tax purposes, for each of the years 1927 to 1934 inclusive.

No. 6 (36 points):

Corporation A has contracts with its sales and production managers whereunder each of the latter is to receive, as extra compensation, two and one-half per cent. of the net book profit of the company for the calendar year 1926, after providing for federal income taxes.

The net book profit for the calendar year 1926, before provision for the extra compensation and for federal income taxes, was $95,000. There were, however, deductions amounting to $5,000 included in the net book profit as stated above, which were unallowable for income-tax purposes.

From the foregoing data, compute the amount of federal income tax payable by the corporation and the amount of extra compensation due to each of the managers.

Examination in Commercial Law

MAY 20, 1927, 9 A. M. TO 12:30 P. M.

Answer ten questions and no more—three on negotiable instruments; three on contracts; two on federal income tax, and one each on partnership and corporations.

Give reasons for all answers.

CONTRACTS

No. 1. Prepare a simple contract with the essential elements arranged in separate paragraphs. Point out the essential elements.

No. 2. How may a seller ship goods to a purchaser, retaining title in himself until the purchase price is paid? How is title then passed when the purchaser makes payment?

No. 3. On May 1, 1927, Shearman signed and sealed a formal written offer to sell to Allen at any time on or before May 15, 1927, certain merchandise at a specified price. On May 5, 1927, Shearman wrote Allen that the offer was canceled and withdrawn. Upon receipt of that letter on May 6, 1927, Allen formally accepted the offer and thereafter sued to enforce the contract. What decision would you render in the action?

No. 4. What is the effect on a contract where a party to it (a) is declared a bankrupt and receives a discharge in bankruptcy; (b) makes a general assignment for the benefit of creditors? What, if any, is the distinction between the two cases?

NEGOTIABLE INSTRUMENTS

No. 5. Is the following a negotiable instrument?

Topeka, Kansas,
Jan. 10, 1927.

To *George W. Brown*, Topeka, Kansas:

Pay to the order of Fred L. Jones $2,000 on account of contract between you and the undersigned.

(Signed) JAMES A. SMITH.

Accepted
(Signed) GEORGE W. BROWN

No. 6. What must a negotiable instrument not contain? What are the exceptions to this rule?

No. 7. A note payable to Moore or order is endorsed "Pay to Neil Bartlett for collection" over Moore's signature. It is then endorsed "Pay to Fred Downs" over Bartlett's signature. Downs collects the amount of the note from the maker. To whom does the money belong?

No. 8. Give an example of a case in which a holder with notice is a holder in due course.

CORPORATIONS

No. 9. X insured certain buildings owned by him with Y Fire Insurance Company against damage by windstorm or tornado, paying the required premium therefor. While the policy was in force the buildings were damaged by wind. When X sought to recover the amount of his damages the company contended as a defense that wind or tornado insurance was not within the scope of its charter powers and that the policy was therefore void. Was such defense good?

No. 10. What is a corporation *de facto?* a corporation *de jure?*

PARTNERSHIP

No. 11. A decides to go into a retail business and to enable him to do so B and C lend A the sum of $10,000 for one year under an agreement in which A agrees to pay to B and C as interest on such loan 5 per cent. of the net profits of the business for one year. Subsequently the X Company, which has sold goods to A, brings suit against A, B and C as copartners, for the unpaid purchase price. Does X corporation recover against B and C?

No. 12. What risks would you deem to be important for careful consideration before you would enter into copartnership with another?

INCOME TAX

No. 13. In 1925 A, a stock broker, has income (after deduction of personal exemptions) of $7,000, but he has suffered a loss of $40,000 in the stock market so that his return for 1926 shows a net loss of $33,000. Can such net loss be used as a deduction from A's gross income in returns for any years subsequent to 1925?

No. 14. The W Company owns a large loft building, part of which it occupies and the balance of which is leased to various tenants under 5-year leases beginning January 1, 1926. In 1926 the company paid out $25,000 to real-estate brokers as their commissions for securing the tenants and for the making of the leases. Is the sum so paid out a proper deduction for income-tax purposes for the year 1926? If not, how is such sum deductible?

Examination in Accounting Theory and Practice

PART II

MAY 20, 1927, 1 P. M. TO 6 P. M.

The candidate must answer questions 1 or 2, 3 or 4 *and* 5 or 6.

No. 1 (48 points):

A fire-insurance company is formed, January 1, 1926, with a capital of $500,000 and paid-in surplus of $250,000. It expects to conduct a business that will result in a premium income (after deducting re-insurance and return premiums) for the first two years of $360,000 and $450,000 respectively and of not less than $630,000 for each succeeding year.

It is desired to keep the commission cost within 25 per cent. and the other operating expenses at $100,000 each year.

For the purpose of the reserve for unearned premiums, it may be assumed (a) that June 30th is the average date of expiry of all premiums and (b) that the premium income is equally divided between one-year, three-year and five-year policies. For the purpose of interest, you may assume that the company received from its investments $40,000 the first year, $50,000 the second year and $60,000 each year thereafter.

You are required to make an estimate of income and expense, in tabular form, for the first five years ending December 31st, assuming the fire-loss ratio to premium income earned to be 50 per cent. Show how much higher a ratio than 50 per cent. the company could bear each year without impairing its capital.

No. 2 (48 points):

You are requested to make a balance-sheet audit of the records of the Arctic Fisheries Corporation, operating fish canneries on Puget Sound and the coast of Alaska.

This corporation has been in operation for one year, having acquired the properties of the Alaska Fisheries Corporation on December 31, 1925, at an agreed price, subsequent to an appraisal of all fixed assets.

A condensed list of balances, as at December 31, 1926, is presented as follows:

	Dr.	*Cr.*
Cash in banks and on hand	$167,163	
Accounts receivable, trade	140,980	
Inventory—canned salmon	102,412	
Inventory—supplies	25,615	
Advances to fishermen	66,965	
Real estate	122,500	
Buildings	518,213	
Labels, trademarks, etc.	24,000	
Equipment	325,337	
Ships	330,000	
Cost of sales	1,366,812	
Selling expenses	42,617	
Discounts allowed	10,614	
Administrative expenses	47,886	
Depreciation expense	30,807	
Interest on bonds	15,000	
Accounts payable		$127,320
Accrued taxes		14,219
Reserve for bad debts		11,646
Reserve for depreciation		30,807
Bonded municipal assessments		12,500
Six per cent. gold bonds		500,000
Sales—canned salmon		1,615,429
Capital		1,000,000
Capital surplus		25,000
	$3,336,921	$3,336,921

In the course of your audit, the following facts are disclosed:

(1) On December 20, 1926, a dividend of 5% on outstanding capital stock, payable January 2, 1927, was declared by the directors.

(2) Cheques were drawn during the first ten days of January, 1927, but were entered in the cashbook under date of December 31, 1926, and applied as follows: on accounts payable $47,036 and for wages $6,739.

(3) During the year, salesmen and other employees had borrowed money from the corporation amounting to $20,000 which was offset by personal cheques received and deposited in the company's bank on January 6, 1927, and entered in the cashbook under date of December 31, 1926. An amount of $10,642 was also collected in the early part of January, 1927, on accounts receivable and this was handled in like manner.

(4) The bonds were secured by a first mortgage on all real estate, buildings, equipment and other fixed assets and carried interest at the rate of 6% per annum, payable semi-annually on January 1st and July 1st. The trust deed contained the following provisions:

(a) That net current assets of $250,000 must be maintained and in no event shall current assets be less than twice the current liabilities.
(b) Current assets to include cash, good current and collectible trade accounts and trade notes receivable, also fishermen's accounts and all inventories.
(c) Current liabilities to include all liabilities except bonds and unmatured instalments on property liens.

(5) Reviewing the operating items for previous years, you find that annual depreciation expense on the old company's statements is approximately the same as for the year 1926, viz.: $30,807, although the fixed asset values are much larger on the new company's books in accordance with the appraisal. Further inspection shows that the rates of depreciation used by the old company (which were considered proper) have been reduced 50% in computing depreciation for 1926, so that the depreciation expense will not be increased as the result of the increase in asset values.

(6) From an analysis of the "ships" account and from information furnished, you find that the following vessels were taken over, at book value, from the old company: steamships Issaquah $40,000, Klondike $40,000 and Dawson $35,000; sailing ships Juneau $15,000 and Skagway $10,000; gasoline boat Mermaid

$25,000. The sailing vessels had been discarded in 1925 and, although valued at $25,000, had a scrap value of not more than $3,500.

In December, 1926, the company purchased two steamers; the Senator costing $90,000 and the Nome $75,000. These boats took the place of all the old equipment which was offered for sale and realized prices in January, 1927, as follows: Issaquah $10,000, Dawson $8,000 and Mermaid $12,000. The Klondike (a sister ship of the Issaquah), the Juneau and the Skagway were retained.

Depreciation on boats was taken, during 1926, as follows: Issaquah $1,000, Klondike $1,000, Dawson $875 and Mermaid $625, a total of $3,500.

It is claimed by the directors that the loss to be sustained on the replacing of the old boats would be more than offset by the appreciation in value of the new steamers, which were bought at a bargain, and you are shown a valuation by a trustworthy appraiser rating these vessels as follows: the Senator $225,000 and the Nome $200,000.

(7) Included in "advances to fishermen," you find charges for nets, etc., amounting to $20,146. These represent the property of the company. The nets, etc., are lent to the fishermen and debited to their accounts as a matter of record. The fishermen are required to maintain the nets in good condition.

From the foregoing data, make what adjusting journal entries you consider necessary. Prepare and submit a balance-sheet with any comments you think appropriate.

No. 3 (20 points):

The capital stock, authorized and outstanding, of the Sabine Corporation consists of 3,000 shares of 6% cumulative preferred stock and 7,500 shares of common stock, all being of the par value of $100 each. The former is preferred both as to capital and to dividends, and the preferred dividends, payable June 30th and December 31st, have been paid to December 31, 1925.

The balance-sheet, as of December 31, 1926, prepared by the company, was as follows:

Assets

Current assets:		
Cash		$23,000
Customers' accounts receivable	$147,500	
Less: Reserve for bad debts	2,500	
		145,000

Inventories at cost:		
Raw materials and supplies		$95,000
Manufactured goods and goods in process		167,000
Total current assets		$430,000
Prepaid expenses		1,700
Fixed assets:		
Land		75,000
Buildings	$325,000	
Machinery and equipment	560,000	
	885,000	
Less: Reserve for depreciation	210,000	
		675,000
Total		$1,181,700

Liabilities

Current liabilities:	
Notes payable—banks	$125,000
Accounts payable—trade creditors	204,200
Accrued liabilities—interest and state taxes	7,500
Total current liabilities	$336,700
Reserve for contingencies	50,000
Stockholders' equity:	
Excess of assets over liabilities	795,000
Total	$1,181,700

You are required to comment on the statement (balance-sheet), as presented and to make such changes in form as you consider appropriate or desirable.

No. 4 (20 points):

Two firms of lawyers—J & K and L & M—decided to amalgamate as at January 1, 1926.

J & K have receivable accounts $8,000, furniture valued at $5,000 and a law library worth $2,500. L & M have receivable accounts $5,500, furniture valued at $3,500 and a law library worth $1,500.

Each firm introduces $5,000 cash, as working capital, and pays off its own liabilities prior to the amalgamation.

The firms guarantee their respective accounts receivable and are to be charged with losses on collection. It is further agreed that each firm shall have a preferential claim of 20% on the gross fees billed during the year 1926 to their own clients. The balance of the net earnings, after charging all expenses, is to be divided as follows: J 35%, K 25%, L 25%, M 15%. The shares of the partners in the assets of the amalgamated firm are to be in the same proportions.

The shares of the partners in the preferential claims of 20% are to be: J seven twelfths, K five twelfths, L five eighths, and M three eighths.

The accounts for the year ended December 31, 1926, showed total earnings of the firm as $65,000, of which $30,000 came from J & K's clients, $25,000 from L & M's clients and $10,000 from new clients. Accounts receivable unpaid (included in the $65,000) amounted to $15,000.

The loss on collection of the original accounts receivable averaged 7% on J & K's accounts and 4% on those of L & M.

Personal withdrawals, which were to be treated as advances against net earnings and not as salaries, were J $5,000, K $6,000, L $3,000 and M $4,000. No interest was to be charged on withdrawals and none allowed on capital.

Working expenses for the year amounted to $20,000.

After depreciating all furniture 15% and each library 30% for the year, prepare accounts showing the distribution of net earnings and a balance-sheet as of December 31, 1926.

No. 5 (32 points):

On December 31, 1926, all the outstanding stock of a corporation (5,000 shares, common, having a par value of $100 a share) was owned by two stockholders, one of whom (Smith) held 4,500 shares and the other (Brown) 500. Earned surplus amounted to $450,000.

To enable Smith to retire from the business and to place Brown in control, a recapitalization was effected in the following manner:

An appraisal of the plant—real estate and machinery—was made, the result being an increase in sound value thereof over the net book value of $1,000,000. Six per cent. sinking-fund gold bonds for $1,000,000, secured by a first mortgage on the plant, were issued at a cost to the corporation of $115,000, representing discount and expense, and with the proceeds therefrom Smith's stock was purchased by the corporation and taken into the treasury at an agreed price of $250 a share. Such treasury stock was then voted out in the form of a dividend in stock to Brown. The corporation then called in all Brown's stock and issued to him in return 500 shares of new preferred stock having a par value of $100 a share and 30,000 shares of new common stock having no par value.

(a) Formulate the journal entries you would use to record the foregoing transactions;

(b) Submit a statement showing the aggregate capital, after refinancing, and the amount of each class thereof, i. e. funded debt, preferred stock, common stock and surplus (if any). Explain the method used in assigning a value to the no-par common stock. How much, if any, of the original earned surplus of $450,000 could, in your opinion, be retained as surplus available for dividends? Give reasons for your decision.

NOTE. The corporation being dealt with was incorporated in a state in which there is no law governing the nominal value of no-par-value stock.

(c) Regardless of the amount of depreciation of fixed assets allowable as a deduction from gross income for tax purposes, state (1) on what plant value you would base depreciation to be charged on the company's books, (2) what proportion of such depreciation you would charge against operations and (3) what proportion, if any, of such depreciation you would charge against no-par-value common stock or earned surplus, or both. Give reasons for your decisions.

No. 6 (32 points):

On December 31, 1926, A is indebted to B in the following amounts:

$1,500 due December 31, 1927, without interest;
$3,500 due December 31, 1929, with interest at the rate of 6% payable annually;
$5,000 due December 31, 1931, with interest at the rate of 6%, from December 31, 1926, not payable until maturity of note but to be compounded annually;
$6,000 due December 31, 1932, with interest at the rate of 5%, payable annually.

On this date (December 31, 1926), A learns that on December 31, 1930, he will fall heir to $20,000 and arranges with B to cancel the four notes in exchange for one note due in four years. It is then agreed that the new note shall include interest to maturity calculated at 5% compounded annually and that B shall not lose by the exchange.

What will be the amount of the new note?

Given at 5%:

$v^1 = .9523810$	$(1+i)^1 = 1.0500000$
$v^2 = .9070295$	$(1+i)^2 = 1.1025000$
$v^3 = .8638376$	$(1+i)^3 = 1.1576250$
$v^5 = .7835262$	$(1+i)^4 = 1.2155062$

Given at 6%:

	$(1+i)^3 = 1.1910160$
	$(1+i)^5 = 1.3382256$