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AMERICAN INSTITUTE OF ACCOUNTANTS

BOARD OF EXAMINERS

Examination in Auditing

NOVEMBER 15, 1923, 9 A. M. to 12.30 P. M.

The candidate must answer all the following questions.

(10 points each)

No. 1. Define—

(a) a balance-sheet.
(b) a comparative balance-sheet.
(c) a consolidated balance-sheet.
(d) a double-account balance-sheet.
(e) a fund balance-sheet.

No. 2. In a detailed audit how would you verify and value the item "accounts receivable"?

No. 3. Do you consider the periodizing of the outstanding accounts-receivable balances as the best method of determining the adequacy of the reserve for bad debts? Give reasons.

No. 4. Corporation A has taken over the assets and liabilities of corporations B and C. The assets and liabilities have been merged with those of corporation A. In what circumstances may the amount of the goodwill account of corporation A be (a) decreased; (b) increased?

No. 5. You are examining the accounts of a mercantile corporation which has several selling branches but all shipments are made and all customers are billed by the main office. It is not intended that you shall visit the branches. Outline a procedure for the verification of the branch balances.

No. 6. On February 15, 1924, you are called on to audit the books of a concern for the calendar year 1923. State in detail how you will verify as of December 31st the balance-sheet items (a) cash, (b) notes receivable and (c) accounts payable?

No. 7. After all credits, exemptions and deductions A and B have net incomes of $7,500 each. All of A's income is derived from dividends on stocks of domestic corporations; B's from salary and commissions. At what rates will each be assessed under the federal income-tax law of 1921?

No. 8. A died February 14, 1923. What return or returns under the federal income-tax law of 1921 should be made by A's executor, and when?

No. 9. In 1917, A bought 100 shares of stock for $10,000. In 1922 he received an "extra dividend from profits earned prior to 1913" of $2,000. Thereupon (1922) he sold the stock for $6,000. What return of these transactions should he make for 1922?

No. 10. In certifying without qualification to a balance-sheet what responsibilities—financial, legal and moral—to your client and to the public will you consider that you have assumed?

Examination in Accounting Theory and Practice

PART I

NOVEMBER 15, 1923, 1 P. M. to 6 P. M.

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

No. 1 (25 points):

The Newton Foundry & Machine Co. has on hand at the beginning of the month $50,000 worth of steel and, in addition, material sufficient to manufacture 100,000 lbs. of castings.

The following is a summary of transactions of the several departments of the business for April:

The foundry department manufactures castings for its own shops and also for customers. One hundred thousand pounds of castings are made during the month at a cost of 10 cents per pound; 50 per cent. of the product goes to the machine shop at 12 cents per pound; 35 per cent. goes direct to customers at 15 cents per pound; 10 per cent. is defective and 5 per cent. remains on hand at the end of the month.

The machine shop withdraws from stores steel to the value of $50,000. Productive labor on the product amounts to 100 per cent. of the cost of the material and the factory overhead to 150 per cent. of the productive labor. The finished product of the department is disposed of at cost plus 10 per cent., as follows: 60 per cent. to the assembling department; 10 per cent. to the shipping department to fill customers' orders; 15 per cent. to the storeroom; 5 per cent. is defective and 10 per cent. remains in process.

The assembling department labor and overhead amounts to 20 per cent. of the cost of the product to this department. Ninety per cent. of the product received is completed and delivered to the shipping department, crated and shipped to customers.

Allowing 5 per cent. of factory cost for shipping department expense, 10 per cent. for selling expense and 10 per cent. for profit, prepare departmental factory accounts and trading account to reflect the foregoing transactions embodying the following:

One whole shipment of merchandise was returned by a customer as not being in accordance with specification and unfit for his purpose. The billing price of this shipment was $10,164; the cost of the assembled product was $8,000.

Give summary of inventories on hand at the close of the period with comments regarding values and submit suggestions for improvement in the methods of accounting.

No. 2 (20 points):

A, B, C and D form a partnership for the purpose of executing certain contracts owned by C. A agrees to allow the partnership the use of a building owned by him, valued at $50,000, for which he is to receive a fair and adequate rental. B agrees to lend securities valued at $50,000, stipulating that he as an individual shall receive the equivalent to the income from said securities. C assigns his contracts to the copartnership, valuing them at $50,000. D agrees to contribute services based upon his knowledge of the processes of manufacture and long experience in the business, which he values at $50,000.

The books of account are opened with the following journal entry:

Buildings	$50,000	
Securities	50,000	
Contracts	50,000	
Manufacturing formulas, etc.	50,000	
To A's capital account		$50,000
B's capital account		50,000
C's capital account		50,000
D's capital account		50,000

No written agreement is drawn but it is understood and mutually agreed that profits shall be divided equally between the four partners.

A manager is appointed with a competent staff, the partners being required to devote little of their time beyond instructing the manager as to their wishes and desires.

After deducting all expenses there remains a net profit, for the period of operation, of $200,000, which is applied as follows:

A's drawing account	$20,000
B's drawing account	20,000
C's drawing account	70,000
D's drawing account	70,000
Undivided	20,000

A and B take exception to the accounts on the ground that C and D are not entitled to withdraw their capital; that they are entitled to one-fourth only of the profits; and that without the use of the property and securities furnished by them (A and B) no profit could have been made.

C and D reply that their contracts and their experience have produced the result and that A and B are getting excellent return for the loan of their properties.

After considerable discussion with no idea of a satisfactory settlement but an express desire to avoid "going to law" it is decided finally to submit the whole matter to arbitration.

You are appointed arbitrator with full powers. Your decision to be final and binding upon all parties.

Present your report and findings, giving reasons for your conclusions.

The opening journal entry must not, of course, be considered as absolute.

No. 3 (10 points):

Are there any circumstances in which depreciation may be charged against an account other than current profit and loss? If so, cite instances, giving reasons.

No. 4 (20 points):

Corporations L, M, N, O and P decide that it is to their mutual advantage to amalgamate.

The following information is on file regarding these corporations:

	Present capital stock and surplus	Average annual net earnings 10-year period	Appraised value, net assets
L	$ 5,250,000	$ 420,000	$ 4,000,000
M	2,500,000	300,000	3,000,000
N	750,000	150,000	1,200,000
O	500,000	110,000	700,000
P	1,000,000	180,000	1,500,000
	$10,000,000	$ 1,160,000	$10,400,000

The directors of the L corporation suggest that the capitalization of the new company be $16,000,000 and that each corporation receive its pro rata share in accordance with the present capitalization, L receiving $8,400,000, M $4,000,000, N $1,200,000, O $800,000 and P $1,600,000.

The plan is favored by all the companies, subject to the approval of their accountants.

On behalf of the M, N, O and P corporations you are asked to criticize the plan and report, submitting an alternate plan if you consider that proposed not equitable to any or all of the companies which you are representing.

No. 5 (25 points):

The following is a statement of the X Y Z Company, July 1, 1923:

ASSETS

Cash in banks and on hand	$ 55,000
Customers' accounts (good)	65,000
Merchandise inventory	80,000
Real estate and building	200,000
Operating equipment	20,000
	$420,000

LIABILITIES

Bills payable	$ 35,000
Accounts payable	45,000
Encumbrance on real estate and building	50,000
Reserve for building depreciation	20,000
Capital stock preferred	10,000
Capital stock common	20,000
Earned surplus	240,000
	$420,000

Jones and Smith each own $10,000 par value of the common stock. They have had a serious dispute with regard to business policy and Smith desires to withdraw from the corporation. As the corporation is a "close" one and Jones is unable to purchase Smith's stock, they consult and request that you outline a plan enabling Smith to retire and not to impair the general credit of the corporation.

Submit your plan and prepare journal entries for putting into effect, on the records of the company, the result of your suggestions.

Prepare a statement of the X Y Z Company after Smith has retired from the business on the basis suggested by you.

ACTUARIAL (OPTIONAL)

No. 6 (25 points):

The annual sinking fund has been fixed at $83,290.94 to redeem a bond issue of $1,000,000 at the end of 10 years. It is argued against this plan that the payments should be $100,000 per annum. Demonstrate which of these two amounts is the correct one, assuming the fund to be invested meantime at 4 per cent. interest, compounded annually. Show also the amount of the saving effected by the smaller sinking fund, discounted to maturity, and the amount to be returned to the borrower at the end of the period if the larger sinking fund ($100,000) were adopted.

[$1.04^{10} = 1{,}480{,}244$.]

Examination in Commercial Law

NOVEMBER 16, 1923, 9 A. M. to 12.30 P. M.

Give reasons for all answers.

(The possible credit for each question is 10 points)

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1. B signed a promissory note in blank, leaving it on his desk. During B's absence from his desk A took the note, filled it in for two hundred dollars and sold it for value to C, who knew nothing about the method by which A came into possession of the note. Could C recover on the note from B?

No. 2. Y gave X a cheque for fifteen hundred dollars in payment of a debt. The cheque was drawn on the Union Trust Company. X had the cheque certified by the Union Trust Company. On the following day, when X was about to deposit the cheque in his own bank, X learned that the Union Trust Company had failed at the opening of business that morning. X then claimed that Y must make good for the cheque. Was X correct in his contention?

No. 3. Define (a) an inland bill of exchange; (b) a foreign bill of exchange. In what circumstances does the determination as to whether a bill of exchange is inland or foreign become a vital point?

No. 4. Name three kinds of indorsement, give an example of each and explain the effect of each.

CONTRACTS

Answer two of the following three questions:

No. 5. Chandler, owner of a chain of grocery stores in Cleveland, Ohio, sold his entire business to Davison. The contract of sale contained an agreement by Chandler not to engage in the grocery business for a period of ten years. Could Davison enforce the agreement mentioned? What would have been the effect if Chandler had agreed not to engage in the grocery business in Cleveland, Ohio, and vicinity for a period of ten years?

No. 6. Under the statute of frauds, what contracts must be in writing?

No. 7. What is specific performance and when may it be granted?

PARTNERSHIP

Answer one of the following two questions.

No. 8. A and B were copartners. They dissolved the partnership, A retiring from the business and B continuing it. After the dissolution B continued to use the same offices, on the door of which A's name remained, and also continued to use the firm's stationery, of all of which A had knowledge. Many concerns not knowing of the dissolution sold goods, as they supposed, to the firm. Upon the insolvency of B they sought to hold A liable. Could they?

No. 9. Weeks and Matthews formed a copartnership for a five-year term. Soon after they began business, Matthews found that Weeks was engaging in wild speculations, was almost continually in a drunken state and was generally so conducting himself as to cause the firm to lose its good name and reputation. Had Matthews any remedy?

CORPORATION

Answer the following two questions:

No. 10. State generally the principal rights of a stockholder.

No. 11. A and B, upon the formation of a corporation, agreed to take certain shares of the corporation's stock. They paid one-fourth of the purchase price, that is, one-fourth of the par value of the stock which it was agreed should be purchased, but failed to make any further payments. The corporation, after conducting business for a time, became insolvent, and the creditors, finding that the corporation had no assets, sued A and B for the balance of the purchase price of the stock which they agreed to purchase. Did the creditors recover?

BANKRUPTCY

Answer the following question:

No. 12. What are the principal duties of a bankrupt under the bankruptcy law?

INCOME TAX

Answer the following question:

No. 13. What credits are allowed a domestic corporation against the corporation's net income before computation of the income tax?

Examination in Accounting Theory and Practice

PART II.

NOVEMBER 16, 1923, 1 P. M. to 6 P. M.

The candidate must answer all the following questions.

No. 1 (27 points):

You are instructed to prepare, for a meeting of creditors, a statement of the debts, liabilities and assets, as at July 31, 1923, of Joseph Herman—trading as the Globe Manufacturing Co.—against whom a petition in bankruptcy was presented by creditors on August 1, 1923.

The statement should show the amounts available for payment of each class of creditors.

The following data have been obtained, partly from the books and partly from information supplied by Herman, the estimates of values being as stated by the debtor.

ASSETS

Works, buildings and land, mortgaged, cost $25,000, estimated value $15,000. Unimproved land, mortgaged, cost $25,000, estimated value $27,500. Dwelling-house, cost $12,000, estimated value $14,000; first mortgage $6,000, interest accrued $150; second mortgage $4,500, at 6 per cent., granted to his wife May 1, 1923, as security for loans of $3,000 on March 1, 1923, and $1,500 on May 1, 1923.

Household furniture, claimed by wife, cost $3,000, estimated value $1,500; auto delivery truck, cost $1,200, estimated value $1,000; passenger car, cost $650, estimated value $350; stock in trade on hand, cost $85,000, estimated value $60,000; stock in trade at agents' for sale, cost $10,000, estimated value $7,500 less advances by agents of $6,000.

Cash on hand and at banks $1,250.

Protested bills and promissory notes on hand $2,500, estimated to realize $750; trade-marks and patents, book value $10,000, estimated to realize $1,000; office furniture and fittings, cost $2,200, estimated value $600; preferred stock of the Enjee tin mines, 60 shares of $100 each full paid, subject to recent assessment of $20 a share under reorganization scheme, estimated value nil; life insurance policy $5,000, surrender value $600 less advance by insurance company $500, assigned to wife March 1, 1923, on condition of her paying future premiums and premium and interest then due amounting to $125.

Disputed claim against Roberts & Co. for breach of contract to purchase goods $3,000, value nil.

Machinery and tools, cost $22,500, estimated value $15,000. Machines bought on hire-purchase system, price $6,000, estimated present value $5,000, payments already made $2,500, estimated equity $1,250.

Accounts receivable—good $18,000; doubtful $7,000, and bad $5,000, estimated to realize $22,000.

Personal property exempt by law, estimated value $200.

J. Herman receives $1,000 per annum from his mother, his father's will having provided a trust fund for three children, and the mother having the right to distribute the income at her discretion and to nominate, by her will, the children who are to receive the principal at her death.

LIABILITIES

Accommodation paper, jointly with Alfred Brown, now bankrupt, $20,000, due August 15, 1923; this bill was discounted and each of the two parties received one half of the proceeds.

Creditors for raw materials of manufacture supplied to debtor (preferential claims under the laws of the state), $15,000; other trade creditors, unsecured, $110,000; notes payable $15,000; notes receivable discounted $6,500, estimated liability $1,500; judgment creditors' claims and costs $970; loan creditor for $21,700 at 6 per cent. interest, partly secured by second mortgage on works for $10,000; interest accrued on $11,700, $410; interest accrued on mortgage of $10,000, $350; loan from wife made July 1, 1923, unsecured, $1,500.

First mortgage on works at 6 per cent., $10,000; interest due June 30, 1923, still unpaid, $350; purchase-money mortgage on unimproved land at 5 per cent., $15,000; interest unpaid since March 31, 1923.

Wages and salaries due—to twenty workmen, one week's wages, $750; to two salesmen, salaries and commissions for July, 1923, $310 and $240; to works manager, salary for July, $400.

Taxes and licences due—federal, $300; state, $1,250; municipal taxes on dwelling-house, $250.

An assessment of $2,200 on the unimproved land, for local improvements, was made three years ago; this was arranged to be paid by ten yearly instalments with interest at 7 per cent.; the interest has been paid to July 31, 1922, and $660 has been paid on account of the principal.

Estimated capital of Joseph Herman, $21,530.

No. 2 (15 points):

A client contemplates investing capital, as a special partner, in a trading business which proposes to manufacture its own products in the future instead of having them made by other concerns.

The business appears to be a profitable one and is not subject to changes of fashion.

Your client has been offered one-third of the net profits on condition that he invest $200,000 as capital and an additional $100,000 as a loan with interest at 6 per cent. per annum. These funds are at present invested to yield an average income of 5 per cent. per annum.

Each of the two working partners has $100,000 capital in the business and during the last five years each has received a salary of $5,000 and a further average profit of 10 per cent. It is proposed to continue the salaries of the two working partners and to charge these and the interest on the $100,000 loan as expense before dividing the profits.

Assuming that the additional funds would earn, at least, the former average profit, show the probable income to your client from the investment.

What advice would you give him for the protection of his interests?

No. 3 (12 points):

How would you deal with the following premium or discounts, in the first and subsequent years:

(a) An issue of preferred shares at a premium;

(b) An issue of bonds at a discount redeemable at par;

(c) An issue of bonds at a discount redeemable at a premium at a fixed date or by purchase in the open market prior to that date. If there were a saving by purchasing in the open market, how should this be treated?

(d) State your opinion as to the correctness of crediting to surplus account a premium on the issue of stock. If so credited, is the premium legally available for distribution as dividend?

No. 4 (38 points):

The Benson Company was incorporated June 1, 1922, for the purpose of building and selling dwelling-houses.

The authorized capital was as follows:

Preferred, cumulative, 7% stock;	1,500 shares of $100 each.....	$150,000
Common stock;	1,500 shares of $ 5 each.....	7,500
		$157,000

At a meeting, after incorporation, the board of directors accepted an offer by the president, in consideration of the issuance to him of $7,500 common stock, to transfer to the company all his rights in a three years' option to purchase 150 lots of unimproved land of the Graham estate at $400 a lot.

On July 1, 1922, the company bought a block of land—120 lots, each 20 by 100 feet—from the Walker estate at $1,000 a lot, the vendor agreeing to do the grading and sewering, make roads and pave sidewalks. A subsequent agreement provided, however, that in consideration of the Benson Co's undertaking this work and assuming liability for a general sewer assessment of $4,800, the vendor should allow the sum of $42,000 from the $120,000 purchase price.

On September 1, 1922, a contract was made with the Eastern Construction Co. for the building of group 1, comprising two detached houses at an estimated cost of $15,000 each and ten semi-detached houses at $12,000 — total $150,000 — all on the Walker estate.

The construction company (hereafter known as the contractor) was to receive a fixed fee of $10,000 for superintendence and management and to charge only the net cost of the labor, material and direct expense of the work, whether done by its own men or by those of sub-contractors. Payments were to be made through the contractor on monthly requisitions.

In consideration of a guarantee to bear any excess of total direct building cost over $172,000 (including the $10,000 fee, but excluding extras) the contractor was to receive 40 per cent. of any saving between the original estimate of $160,000 and the guaranteed maximum cost of $172,000.

Extras were to be charged at cost plus a varying percentage for superintendence.

Building operations—group 1—began October 1, 1922, and were completed March 31, 1923.

A contract was made by the Benson Co. direct with the Valgimigli Co., March 1, 1923, for the excavation work and concrete foundations of two additional groups of houses on the Walker estate land as follows:

Group 2: for 10 semi-detached houses, contract price..	$8,500
Group 3: for a terrace of 12 houses, contract price ...	6,800

Changes were made subsequently which increased these costs.

The total land of the Walker estate used for building operations was 45 lots as shown below:

Group 1: Riley avenue.
  For each of 2 detached houses.............45 ft. frontage
  For each of 10 semi-detached houses ......31 ft. frontage
Group 2: Riley avenue.
  For each of 10 semi-detached houses ......30 ft. frontage
Group 3: Neild avenue.
  For the terrace of 12 houses ....200 ft. frontage in all

The land was to be charged against completed houses at the rate of $1,000 a lot of 20 feet frontage.

Some of the houses were sold for cash outright; others with first and second mortgages. Two were sold direct; the rest through agents. The first mortgages were transferred from the building mortgages to the purchasers of the houses; the second mortgages were first taken by the Benson Co., which afterwards sold them at a discount.

The following is a list of balances on the books of the Benson Co. at May 31, 1923:

	Dr.	Cr.
Land purchase, Walker estate, 120 lots	$120,000	
Reserve for development of above land		$ 42,000
Surveys of Walker land	650	
Removal and storage, 600 loads of top-soil	1,500	
Option on 150 lots, unimproved land, Graham estate	7,500	
Sales from sand-pit, Walker land		1,200
Sales of top-soil, 90 loads		450
Field office, cost of building	1,650	
Assessment on 120 lots, Walker land, for district sewer	4,800	
Organization expense, legal and other charges	1,620	
Retaining fee to lawyer, one year to May 31, 1923	1,000	
Legal charges for mortgages and sales of houses	450	
Real-estate taxes on 120 lots, Walker land, to May 31, 1923	2,400	
Outstanding first mortgages on houses unsold, 1 detached, $9,000; 1 semi-detached, $7,000		16,000
Commissions, etc., on building loans	4,800	
Interest, etc., on building loans	750	
General expense, June 1 to November 30, 1922	8,200	
General expense, December 1 to May 31, 1923	5,500	
Capital stock issued, preferred, 7% cumulative		125,000
Capital stock issued, common		7,500
Group 1—		
Paid to contractor, on requisitions	156,600	
Paid to contractor, fixed fee	10,000	
Paid to contractor, for extras and other fees	24,310	
(Apportion the above three items, 10% on each detached and 8% on each semi-detached house)		
Balance due to contractor for group 1		1,910
Transfer of labor and material to group 2		175
Transfer of labor and material to group 3		125
Inspection fees for houses	250	
Gifts and bonuses for houses	150	

	Dr.	Cr.
Compensation paid for cancellation of order for mill work because of changes in plans	1,500	
Hire-purchase instalments, saw-mill	150	
Fire insurance on 12 houses	90	
Coal for heating houses during construction	320	
Planting gardens and making lawns, 12 houses (Apportion according to feet frontage)	2,000	
Sales of houses—		
1 detached		28,500
9 semi-detached		191,650
Loss on sales of second mortgages—		
1 detached house	2,100	
6 semi-detached houses	10,375	
Commissions on sales of houses—		
1 detached	662	
6 semi-detached	3,200	
Grading (one-half each, groups 1 and 2)	4,500	
Sewering (one-half each, groups 1 and 2)	2,500	
Development, 75 unimproved lots, Walker land	13,400	
Architect's fees for plans, specifications and supervision—		
Group 1	4,000	
Group 2	620	
Group 3	600	
Balance due to architect		1,220
Work billed and paid, group 2	9,500	
Work billed and paid, group 3	7,200	
Valgimigli company, 10% retained		1,670
Group 2, transfer from group 1	175	
Group 3, transfer from group 1	125	
Hire-purchase payments, concrete-mixer (Used equally in groups 1, 2 and 3)	420	
Office furniture and fixtures	800	
Petty-cash balance	250	
Fire insurance, field office	15	
Notes payable		10,000
First National Bank	15,768	

From the foregoing, prepare:

(a) Statement showing the profit or loss on the operations for the period to May 31, 1923, with the average cost and gross profits on the detached and semi-detached houses sold.

(b) Balance-sheet as at June 1 (May 31), 1923, after making such adjustments, provisions for reserves, etc., as you think necessary from the details presented and from the following audit notes:

One detached and one semi-detached house of group 1 remained unsold May 31, 1923.

Plant, material and loose tools remaining on hand from group 1 operations were valued at $2,250. The original cost, $3,500, had been charged to material of group 1.

The field office was estimated to have a scrap value of $150 after three years' use.

The contractor for group 1 is to be charged $250 for use of the field office.

Of top-soil stored 510 loads were on hand May 31, 1923.

On first mortgages of $16,000 on houses unsold interest at the rate of 6 per cent. per annum had been paid to March 31, 1923.

Fifty per cent. of amount paid for hire-purchases instalments is to be written off for wear and tear.

The by-laws of the company provide for salaries as follows: The president is to receive 10 per cent. of the net profits for management; a further 10 per cent. is to be divided amongst five other directors.

No. 5 (8 points):

The vendor of a business to a corporation has taken part of the purchase price in preferred and common stock.

On account of a decline of the annual profits, the vendor makes a gift to the corporation of $100,000 preferred stock, to be sold for the benefit of the corporation.

How should this be treated on the books of the corporation? May the $100,000 be used for payment of dividends?