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AMERICAN INSTITUTE OF ACCOUNTANTS

BOARD OF EXAMINERS

Examination in Auditing

MAY 18, 1922, 9 A. M. to 12.30 P. M.

Answer all questions.

No. 1 (10 points):

In listing the balances from creditors' ledger (assumed to be in agreement with controlling account) you find several debit balances. State three causes which may account for these. How would you treat cases arising from each cause?

No. 2 (15 points):

(a) Give particulars of the nature of the examination you would make of inventories submitted to you as representing merchandise and the operating supplies on hand at the date of the balance-sheet of a retail grocery business operating a chain of stores.

(b) The company's sales are on a "cash" basis. The balance-sheet shows that the only assets are inventories and cash, the inventories representing 90% of the total assets. Would that condition suggest to you the need for any special consideration as to the extent of the auditor's examination of the inventories?

No. 3 (10 points):

State in detail how you would audit and verify the notes receivable of a large trading corporation with several affiliated concerns, giving due attention to collateral, notes discounted, makers, etc.

No. 4 (10 points):

The T. N. T. Corporation is organized October 1, 1921, to exploit a new and untried patent. On that date it issues its entire capital stock of no par value, 100 shares for cash at $100 a share, and 900 shares for the patent, the latter being expressly stated in the authorizing resolution as "having no cash value." Its fiscal year is fixed as beginning January 1st, and on December 31, 1921, the treasurer makes up the corporation's first income-tax return based on the following:

Balance-sheet

Cash	$1,000	Capital stock (1,000 shs.)	$100,000
Patent	90,000		
Plant and equipment	7,000		
Expenses to date	2,000		
	$100,000		$100,000

Across the face of schedule A of the income-tax return the treasurer writes: "No business done as yet so there is no net income to report." In schedule B he writes,

"Cash paid in	$10,000
"Patent (25% of stock issued, said stock valued at same amount as that sold for cash on same date)	22,500
"Total invested capital	$32,500"

He submits this return and balance-sheet to you for your criticisms. What are they? Give reasons.

No. 5 (8 points):

To what extent is it an auditor's duty to concern himself with the validity of transactions coming under his notice?

No. 6 (10 points):

In making up an income-tax return for a client an auditor makes a serious clerical error in calculations. The client files the return as made and pays the tax. Two years later the Treasury Department calls attention to the error, and it appears that the client has paid a larger tax than he should have paid. What is the duty of the auditor in the case?

No. 7 (10 points):

A corporation has insured the life of its president for its own benefit and is carrying the amount of premiums paid on its balance-sheet. What position should an auditor take in regard to these premiums?

No. 8 (7 points):

Explain the points of difference in procedure in a detailed audit of earnings and expenses and in a balance-sheet audit.

No. 9 (10 points):

"Net income" of individuals is defined in the income-tax law of 1921 as "the gross income as defined in section 213 less the deductions allowed by section 214." Name (in brief titles ignoring provisos and exceptions) six items of allowable deductions. What are some unallowable expenses?

No. 10 (10 points):

The town of X erects a school building from the proceeds of bonds issued for the purpose. The building is estimated to last twenty years. The bonds also mature in twenty years, and contain a sinking-fund clause to provide the funds for their payment at maturity. The school board makes no provision for depreciation on the building in the annual tax rate, and a controversy arises in the town as to whether or not such provision should be made. Discuss briefly both sides of this question.

Examination in Accounting Theory and Practice

PART I.

MAY 18, 1922, 1 P. M. to 6 P. M.

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

No. 1 (30 points):

A, B, C and D have been in partnership for three years, but, a misunderstanding having arisen, negotiations are in progress with intent to induce D to withdraw. The articles of partnership provide that the partners shall not be allowed any salaries but shall be permitted to make cash drawings of $175.00 monthly. These amounts were drawn the first year. Then, by mutual consent, the drawings were increased the second year to $200.00 each and the third year to $225.00 each.

You are called upon to determine the amount to which D will be entitled if he decides to withdraw; and, in your examination of the books, you find the following facts which have not previously been brought to the attention of the partners.

The bookkeeper has charged the drawings to profit-and-loss, has not provided reserves for depreciation or bad debts; and it is now agreed that proper adjustment shall be made of these particular items.

An analysis discloses the following facts with regard to bad debt losses:

	First year	Second year	Third year	Total
Losses charged off as ascertained....	$139.50	$378.60	$489.75	$1,007.85
Reserve which should be set up at the present time	......	......	......	615.85
Losses which arose from sales in various years	523.60	436.95	663.15	1,623.70

Annual depreciation is agreed upon at the rate of 5% of the cost of the buildings and at the rate of 10% of the cost of the furniture and fixtures which have appeared on the books with the following balances:

	Buildings	Furniture and fixtures
Beginning of first year	$5,400.00	$ 950.00
Beginning of second year	5,950.00	1,075.00
Beginning of third year	6,200.00	1,215.00

The profits as ascertained have been credited to the partners' capital accounts in the agreed profit-and-loss ratios, and no other entries have been made in these accounts.

The following is an abstract of the capitals:

	A	B	C	D
Capitals, beginning of first year..	$5,000.00	$8,000.00	$12,000.00	$15,000.00
Profits, first year	486.00	972.00	1,458.00	1,944.00
Capitals, beginning of second year	$5,486.00	$8,972.00	$13,458.00	$16,944.00
Profits, second year	685.20	1,142.00	1,827.20	2,055.60
Capitals, beginning of third year..	$6,171.20	$10,114.00	$15,285.20	$18,999.60
Profits, third year	822.25	1,391.50	2,087.25	2,024.00
Capitals, end of third year	$6,993.45	$11,505.50	$17,372.45	$21,023.60

The partnership articles provide that in the event of the withdrawal of any partner by mutual consent at the end of any year, the goodwill of the partnership shall be valued at 1½ years' purchase of the profits of the last year in excess of 6% of the total capital at the beginning of that year.

Show what amount D will be entitled to receive if he withdraws.

No. 2 (27 points):

You are called upon to prepare an adjusted statement of the surplus of the Washburn Manufacturing Company at December 31, 1918, and of the profits for 1919, 1920 and 1921.

The surplus account on the company's books appears as follows:

SURPLUS

Dividends, 1919	$40,000.00	Balance, Dec. 31, 1918..	$235,000.00
" 1920	35,000.00	Profits, 1919	65,000.00
" 1921	20,000.00	" 1920	78,300.00
Balance, Dec. 31, 1921..	331,300.00	" 1921	48,000.00
	$426,300.00		$426,300.00

The company has not provided for accruals and deferred items in closing its books and has ignored the following items at the various dates of closing:

	Deferred charges	Deferred income	Accrued expenses	Accrued income
December, 31, 1918	$2,125.00	....	$5,200.00	$475.00
" 31, 1919	2,640.00	....	3,135.00	....
" 31, 1920	3,100.00	$1,250.00	6,120.00	290.00
" 31, 1921	1,950.00	700.00	4,200.00	....

In closing the books the inventories were priced at cost or market, whichever was lower, and, in addition, reserves for possible future declines in market value were set up as follows:

At December 31, 1919	$ 8,000.00
" " 31, 1920	12,600.00
" " 31, 1921	9,250.00

Each reserve was set up by a charge to profit-and-loss and remained on the books until the next closing, when it was credited to the account with the opening inventory. The reserve set up at the end of 1921 is still on the books.

Consigned goods have been included in the inventories at billed price. The company has billed all goods sent to consignees at 130% of cost. The following consigned goods inventories have been included:

At December 31, 1919	$15,600.00
" " 31, 1920	10,400.00
" " 31, 1921	18,200.00

Prepare a corrected statement of the surplus account from December 31, 1918, to December 31, 1921.

No. 3 (10 points):

A corporation issued $100,000.00 of 6% preferred stock on January 1, 1921, with a sinking-fund provision requiring that there shall be redeemed each year out of profits an amount of stock equal to 20% of the profits of the preceding year. The company is not to pay more than 105 for the stock, and any money in the fund which cannot be used to acquire stock at 105 or less is to remain in the fund until purchases can be made.

During 1921 the company made a profit of $29,000.00, and in January, 1922, it created the fund in accordance with the provisions of the stock issue. During February it purchased and retired 56 shares of preferred stock at 103.

Give entries for the establishment of the fund and the purchase and retirement of the stock.

Explain the difference between the operation of a sinking fund for bonds and a sinking fund for stock.

State whether you think it is obligatory for the corporation to set up a sinking-fund reserve in conjunction with a preferred stock sinking fund. If you think that the reserve is not obligatory, state whether or not it is advisable, giving your reasons.

If a reserve is created, state what entry is made to establish the reserve and what disposition may eventually be made of it.

No. 4 (10 points):

In consolidating the statements of a foreign branch with the statements of the home office, it is necessary to make conversions from foreign to domestic currency. At what rates should the balances of the following accounts be converted? Give your reasons.

Fixed assets.
Inventories at the beginning of the period.
Current assets.
Current liabilities.
Nominal accounts.

No. 5 (23 points):

The A Company's balance-sheet at December 31, 1921, contained the following accounts:

Capital stock authorized	$200,000.00
Unissued stock	30,000.00
Treasury stock (50 shares—par 100) cost	7,500.00
Surplus	20,000.00

Capital surplus (from appraiser's revaluation of fixed assets)	4,500.00
Premium on stock (issued at 110)	17,000.00
Reserve for sinking fund	35,320.00
Reserve for extension of plant	20,000.00

On the same date the B Company bought 90% of the outstanding stock at 170 and acquired the treasury stock and the unissued stock at 150.

Compute, for consolidated balance-sheet purposes, the goodwill arising from the transactions.

(ACTUARIAL)

No. 6 (23 points):

A music house sells pianos on the instalment plan, receiving monthly payments. Pianos cost $600.00 and are sold for $900.00. Interest at 6% a year or ½% a month is charged on unpaid balances of the purchase price. Income each year is computed by taking such a proportion of the total profit as the collections on principal during the year bear to the $900.00 selling price. In addition, income is credited with interest collected and accrued during the year.

A piano is sold August 16, 1921. An initial payment of $50.00 is received and the purchaser agrees to pay the balance in 30 equal monthly instalments, payable on the 16th of each month, beginning September 16, 1921. These equal monthly payments are to be applied first to the interest accrued during the month and second to the principal. As the interest will decrease each month, the payment on principal will increase.

(a) Compute the monthly payment to be made. (The present value of $1.00 due 30 periods hence at ½% per period is $.8610297.)

(b) Set up a table with the following columns:

Date	Payments			Balance of Principal
	Total	Interest	Principal	

Enter the payments received in August, September, October, November and December and show the balance unpaid at December 16, 1921.

(c) State the total credit to income during 1921, including profit on sale and interest.

Examination in Commercial Law

MAY 19, 1922, 9 A. M. to 12.30 P. M.

Give reasons for all answers.

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1 (10 points):

To what requirements must an instrument conform to render it negotiable?

No. 2 (10 points):

How is a person secondarily liable on a negotiable instrument discharged from liability?

No. 3 (10 points):

What is the effect of a material alteration of a negotiable instrument and what constitutes a material alteration?

No. 4 (10 points):

Rowe, private secretary for Foster, brought to Foster a cheque for signature payable to cash. The cheque was made out in figures for $50.00, but no words were inserted in the space left for writing. Rowe raised the cheque to $500.00, which Foster's bank paid. Was the bank liable?

CONTRACTS

Answer two of the following three questions:

No. 5 (10 points):

Define (a) a bailment, (b) a conditional sale.

No. 6 (10 points):

A, in Chicago, sold certain goods to B in Boston. The goods were shipped to B by express. After shipment, and while the goods were in the possession of the express company, A ascertained that B was insolvent and unable to pay for his purchase. A notified the agent of the express company at Boston, in whose custody the goods were, to withhold delivery to B and to return the goods to A. The goods were, however, delivered to B upon his payment of the express charges. A sued the express company for conversion. Could he recover?

No. 7 (10 points):

What is meant (a) by the words "substantial performance" as applied to contracts; (b) by the term "quantum meruit"?

PARTNERSHIPS

Answer one of the following two questions:

No. 8 (10 points):

X acquired the interest of A in the copartnership of A and B by purchase at a sale under execution issued on a judgment against A individually. Subsequently A and B gave a chattel mortgage on firm property to Y, a firm creditor. Were X's rights in the property superior to Y's or vice versa?

No. 9 (10 points):

What is a limited partnership?

CORPORATIONS

Answer both the following questions:

No. 10 (10 points):

A corporation is formed in Delaware which is empowered by its charter or certificate of incorporation to do business in all states of the United States. Specify what steps in general should be taken by the corporation before operating in states other than Delaware and what would be the result, if any, of failure to take such steps?

No. 11 (10 points):

Is there any distinction between the "capital" and the "capital stock" of a corporation, and if so, explain such distinction.

BANKRUPTCY

Answer the following question:

No. 12 (10 points):

What is the difference between a receiver in bankruptcy and a trustee in bankruptcy?

FEDERAL INCOME TAX

Answer the following question:

No. 13 (10 points):

Explain the meaning of depreciation and of depletion as used in the federal income-tax act.

Examination in Accounting Theory and Practice
PART II.

MAY 19, 1922, 1 P. M. to 6 P. M.

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

No. 1 (30 points):

The K&L Motors Company, a close corporation, whose records show assets amounting to $9,090, exclusive of goodwill, and liabilities of $3,330, is reorganized with an authorized capital stock of $500,000, $100,000 of which is issued to the stockholders of the old company in lieu of their present holdings, the balance to be issued as circumstances warrant.

The company (reorganized) commences business on the first day of March, 1920, under new management—transferring the balances noted above—and begins to dispose of its capital stock at a sacrifice in order to provide working capital. The funds provided by this means are expended quite freely in an attempt to exploit the business. At the end of the period of nine months (November 30, 1920), the sales of capital stock having fallen off considerably, the company is in difficulty.

The balances on the books at this date are as follows:

	Dr.	Cr.
Machinery and fixtures	$3,959	
Tools and supplies	3,758	
Demonstration equipment	1,550	
Material and parts inventory, commencement	1,911	
Patterns	2,413	
Patents	419	
Office furniture and fixtures	1,611	
Cash in bank	6,280	
Petty cash, executive office	153	
Petty cash, factory	17	
Notes receivable	1,875	
Accounts receivable	26,881	
Insurance premiums unexpired	439	
Notes payable		$23,500
Accounts payable		9,587
Loans, bank		4,784
Loans, personal		15,467
Royalties due and unpaid		564
Salaries due and unpaid		500
Commissions due and unpaid		265
Capital stock authorized		500,000
Capital stock unissued	$319,660	
Discount on capital stock	35,364	
Goodwill	94,240	
Contract orders outstanding		$8,792

	Dr.	Cr.
Purchases:		
Material and parts for tractors	$63,369	
Material and parts for trailers	351	
Material and parts for 5th-wheel tractors	6,970	
Material and parts for repairs	714	
Material and parts for power belt attachment.	27	
Sales:		
5th-wheel tractors		$ 1,125
Farm tractors		64,350
Power belt attachments		17
Material and parts		4,377
Labor		1,027
Incidentals		180
Rent, factory	1,745	
Rent, executive office	974	
Salaries, executive office	3,430	
Salaries, factory office	1,511	
Management, factory	4,500	
Foremen	1,419	
Labor (wages)	10,183	
Power, light and heat	376	
Demonstration	811	
Maintenance, equipment	316	
Advertising	10,746	
Printing and stationery	2,045	
Freight and storage	4,209	
Drafting	82	
Telephone and telegrams	592	
Traveling	2,245	
Commissions	7,842	
Insurance	234	
Collections and exchanges	44	
Shipping	268	
Interest	238	
Royalties	750	
Discounts and allowances	544	
Professional services	600	
Advances against commissions	685	
Advances for traveling	1,526	
Incidentals, manufacturing	1,800	
Incidentals, sales department	714	
Incidentals, office	385	
Reorganization expenses	1,760	

The inventories as at November 30, 1920, were:

Material and parts:	
For farm tractors and miscellaneous	$29,234
5th-wheel tractors	9,642
Repairs	1,150
	$40,026

The management, realizing that a heavy loss has been sustained, conceives the idea of capitalizing a large portion of its expenses in order to make a more favorable statement to present to its bank in an application for a loan, and the bookkeeper is instructed to make the journal entry as follows:

NOVEMBER 30, 1920		
"Foundation" account	$35,399	
To sundries:		
Reorganization expenses		$1,760
Salaries, executive office		1,697
Salaries, factory office		1,304
Labor (wages)		7,419
Management, factory		3,500
Foremen		1,049
Rent, executive office		641
Rent, factory		1,345
Power, light and heat		300
Maintenance, equipment		273
Demonstration		623
Drafting		76
Collections and exchanges		14
Incidentals, office		261
Incidentals, manufacturing		1,619
Incidentals, sales department		40
Advertising		6,300
Freight and storage		3,112
Shipping		31
Telephone and telegrams		376
Printing and stationery		1,522
Discounts and allowances		409
Traveling		1,030
Commissions		698

"Transferring the foregoing expense accounts respectively maintained to and including September 30, 1920, to foundation account, said expenses being incurred in the establishment of the Forma-Tractor, etc., on 'the market,' the effectiveness thereof being apparent from October 1, 1920, in the marked increase of sales as shown by the books."

An accountant is then asked to prepare balance-sheet and operating account from the adjusted trial balance and to certify thereto. He prepares the statements as requested but refuses a certificate, giving his reasons, although the management contends that it is justified in its request and cites two instances in which requests under similar conditions received favorable consideration. The accountant, however, presenting facts in his report, takes occasion to refer to the increase of sales during the last two months as probably the result of the expenditures in "pioneering."

You are asked to prepare the statements, balance-sheet and operating account, giving particular attention to the proper classification in each and to comment briefly upon the attitude of the accountant and the contention of the management.

NOTE—*Do not waste time in making unnecessary transcripts of lists of balances placed before you.*

No. 2 (27 points):

A. B. and members of his family own all the capital stock of the A. B. Manufacturing Co. They have entered into an agreement with C. D. whereby he is to form a new corporation—the C. D. Company, Inc.—which will acquire the A. B. Manufacturing Co., taking over its assets and assuming its liabilities. The A. B. Manufacturing Co's balance-sheet appears as follows:

Assets	
Plant, less depreciation (book value)	$1,000,000.00
Cash	50,000.00
Accounts receivable	200,000.00
Inventories	600,000.00
Deferred charges (insurance, etc.)	5,000.00
	$1,855,000.00
Liabilities	
Capital stock, common	$1,250,000.00
Notes payable	200,000.00
Accounts payable and accruals	250,000.00
Surplus	155,000.00
	$1,855,000.00

The terms of the agreement are:

(1) For their present holdings and surplus of the A. B. Manufacturing Co., A. B. and his family shall receive common stock and 7 per cent. preferred stock in equal amounts at par. The present holdings and surplus of the A. B. Manufacturing Co. shall be determined by an examination to be made by a certified public accountant, after substituting for the book value of the plant the appraised value of $1,375,000.

(2) A. B. and his family are also to receive shares of common stock of $100 each par value for the goodwill, which is to be considered as equivalent to three times the average annual net profits of the previous five years before charging interest and taxes.

(3) C. D. is to subscribe for $500,000.00 of twenty-year bonds of the new corporation to be issued at 95 net to the corporation, the discount to be capitalized and to be amortized over the life of the bonds.

(4) The expenses of the organization of the new corporation are to be borne by it and are to be capitalized temporarily and written off during the next three years.

The profits, as adjusted by the auditor, were:

First year	$ 60,000.00
Second year	80,000.00
Third year	100,000.00
Fourth year	125,000.00
Fifth year	135,000.00

and the necessity was reported for (1) a reserve for bad and doubtful accounts of $12,000.00; (2) a reduction in the amount of inventories of $24,000.00 for obsolete stock, errors, etc., and (3) an increase of $1,500.00 accounts payable for expense invoices not recorded.

Prepare a statement in columnar form showing:

(a) The balance-sheet of the A. B. Manufacturing Co. as shown above without adjustments,

(b) The adjustments and financing in accordance with the contractual arrangements, and

(c) The balance-sheet of the C. D. Company, Inc., after giving effect to all adjustments and financing required under the contractual arrangements.

No. 3 (10 points):

An expression of your opinion is desired regarding the following:

Is it legal or sound business policy under any conditions for a corporation to declare a dividend out of current earnings while its capital is impaired?

Is it ever justifiable to pay dividends with borrowed money?

No. 4 (10 points):

What is the significance of the item on the assets side of a balance-sheet usually described as "prepaid or deferred charges" and of that on the liabilities side as "wages or other expenses accrued"?

No. 5 (23 points):

The X Corporation, under contract, furnishes the M Company part of its raw material. This contract at expiration will not be renewed. The M Company, unable to purchase this particular material elsewhere, decides to buy an unused plant and to equip it with the necessary machinery with which to produce the required material.

To help finance this purchase and to acquire enough raw material for the new plant, the company borrows from its bankers $25,000.00 prior to December 31, 1919, and $175,000.00 during 1920. Of this amount $45,000.00 has been repaid in 1920, leaving a balance of $155,000.00 due the bankers on December 31, 1920.

This loan has been in the form of short-term notes which are renewed from time to time.

On December 31, 1920, the bankers suggest to the M Company that, inasmuch as the loan was principally invested in the fixed assets of the company, it should be converted into a mortgage bond issue.

The M Company, which is a close corporation, feels that, while the loan did help finance the plant purchase, it is now practically financing their current operations and the company wishes you to use the two accompanying balance-sheets and other information derived therefrom to formulate a report which it may present to its bankers in support of its views.

Prepare such statements as you think necessary and draft a letter explaining how such statements support the views of the M Company.

The M Company

Balance-sheet—December 31, 1919 and 1920

Assets	December 31, 1919	December 31, 1920
Cash	$ 37,000.00	$ 36,000.00
Receivables	118,000.00	152,000.00
Inventories	231,000.00	360,000.00
Machinery and equipment	82,000.00	101,000.00
Buildings	58,700.00	116,500.00
Land	45,800.00	68,500.00
Deferred charges	3,850.00	22,300.00
	$576,350.00	$856,300.00
Liabilities		
Accounts payable	$ 1,800.00	$ 26,000.00
Accrued federal taxes *	4,300.00	26,800.00
Notes payable—banks	25,000.00	155,000.00
Reserve for depreciation	37,200.00	42,510.00
Capital stock	400,000.00	400,000.00
Surplus †	108,050.00	205,990.00
	$576,350.00	$856,300.00

* Federal taxes were computed and charged against profits before closing the books each year.

† No dividends were paid in 1920.

No. 6 (23 points):

An audit of a set of accounts in order to determine the true profits for the years 1920 and 1921 revealed the following:

On the books of the home office, the account "branch office account current" showed a debit balance of $12,250.00 at December 31, 1920, which was erroneously written off to profit-and-loss. At December 31, 1921, a credit balance of $2,050.00 was shown and this also was transferred to profit-and-loss.

An examination of the branch office records disclosed the keeping of asset and liability as well as revenue and expense accounts, and a balance-sheet, as at December 31, 1920, showed a net worth of $17,700.00 credited to the home office. Another balance-sheet, as at December 31, 1921, showed a net worth of $8,500.00.

Before the closing of revenue and expense accounts for 1920, the relative accounts on both home office and branch books were in agreement, except that a draft of $1,500.00 drawn and recorded by the branch in 1920 was paid and recorded by the home office in 1921.

The results of the closing of the branch office accounts had not been recorded on the home office books.

Make required adjustments and state:

(a) What effect said adjustments would have on the profit showing for each of the years 1920 and 1921 on the home office books and

(b) What correction is necessitated in the amount of invested capital, December 31, 1920.