Journal of Accountancy

Volume 64 | Issue 6 Article 13

12-1937

American Institute of Accountants' Examinations, November 18 and 19, 1937

American Institute of Accountants. Board of Examiners

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 on November 18 and 19, 1937.]

BOARD OF EXAMINERS

Examination in Auditing

NOVEMBER 18, 1937, 9 A.M. TO 12:30 P.M.

The candidate must answer question 1; any three of next four questions (2 through 5); and any seven of the last nine questions (6 through 14).

Answer the following question

No. 1 (6 points):

The owner of the Hanover Hardware Company, a large hardware store, suspects an employee of defalcation. He engages you to make a limited investigation, primarily for the purpose of discovering whether or not his suspicions are justified. You find that the employee has charge of the accounts receivable detail over which no control is kept in the general ledger, also that he has access to the cash drawer in which proceeds of cash sales are kept. No one individual has exclusive charge of cash receipts and no attempt is made to deposit the total receipts each day, deposits being made from the cash drawer in even hundreds of dollars whenever deemed advisable by the manager. All checks received from customers, however, are to be deposited the day received. State two steps which you would take to aid you in forming your opinion.

Answer any three of the following four questions

No. 2 (15 points):

The Standard Manufacturing Corporation sold 10,000 shares of preferred stock at 90 in 1936. The preferred stock is without par value, has a preference as to assets of $100 a share, and is convertible into common stock in the ratio of one share of preferred to two shares of common. The common stock has a par value of $20 a share.

The corporation has ample earned surplus, and by action of the board of directors in December, 1936, subsequently approved by the stockholders, $100,000 of earned surplus was appropriated to bring the preferred-capital-stock account up to the liquidating value of $100 a share.

During the year 1937 one thousand shares of preferred stock, recorded on the books at an aggregate value of $100,000, were converted into 2,000 shares of common stock, having an aggregate par value of $40,000.

A states that the difference of $60,000 should be credited to earned surplus as a partial restoration of the previous charge of $100,000. B says the credit should go to the capital surplus until such time as there is available the full amount of $100,000 for transfer to earned surplus. C says that the credit to earned surplus should be at the rate of $10 a share on the 1000 shares preferred that were converted into 2000 shares common, or $10,000, thereby reducing the $100,000 previously charged. Inasmuch as this is the first year conversions of preferred stock into common stock have taken place, it is desired to establish a definite policy for the future and for this purpose A, B, and C come to you for advice. What treatment would you recommend? Give reasons.

No. 3 (15 points):

The H Fund, an incorporated philanthropic organization, whose office is located in the City of New York, was organized in 1924. The principal assets of the fund consist of investment securities donated by its founder or bequeathed at his death. The investment activities of the Fund are supervised by an investment committee, whose members are appointed by the C Trust Company. The operating activities are controlled by the executive committee and administered by a general manager who employs a staff consisting of several physicians and research assistants, a statistician, and a clerical force. Approximately 15% of the Fund's annual income is required for administrative expenses. Practically all the remainder is donated, principally to assist rural communities in the erection of hospitals. Communities aided are required to contribute a certain proportion (which varies according to the individual case) of the construction costs, the Fund's contribution being made contingent upon the approval of construction plans by its medical staff and submission of architects' certificates as to work completed. Donations are also made to medical schools and, occasionally, to various other organizations in the scientific field.

You are to make an audit of the accounts of the Fund for the year ended December 31, 1936. Give (1) four operations which should be performed in the verification of investments and income therefrom and (2) four operations which would be effective in the verification of disbursements for donations.

No. 4 (15 points):

A company, whose general office is in New York, maintains bank accounts in which receipts are deposited and from which disbursements are made, in the usual course of business, at Bank A, located in New York, and Bank B, located in Chicago. The general office procedure relating to cash disbursements requires, among other things, that invoices and payrolls be approved by the department heads concerned, and that checks be signed by the cashier and countersigned by the office manager. It is also the practice for the cashier to receive the monthly bank statements, reconcile the bank accounts and turn over the bank statements, canceled checks and other memoranda to the office manager, who checks the reconcilements. Protected paper is used on disbursement checks and such checks are serially numbered.

On December 10, 1936, the general office cashier embezzles $5,000 from the company by drawing a check to his own order on Bank A, to which he successfully forges the office manager's counter-signature. No entry of this disbursement is made in the cashbook. On December 31, 1936, the cashier draws a check on Bank B for $5,000 to the order of Bank A, and obtains the office manager's counter-signature by explaining that the check is in connection with a transfer of funds. The cashier deposits the second check in Bank A on December 31, 1936, but makes no cashbook entries for the receipt in Bank A or the disbursement from Bank B. Upon receipt of the December bank statement from Bank A, the cashier destroys the check paid by that bank which he drew on December 10th. The office manager, in checking the bank reconcilement, does not discover the embezzlement.

You are engaged to make an examination of Company A's accounts for the year ended December 31, 1936, and begin your examination on the morning of January 18th.

(1) What type of defalcation does this case illustrate?

(2) Specify and briefly describe three methods of verifying cash balances and transactions by which this type of defalcation should be detected.

No. 5 (15 points):

The A B C Corporation has an operating deficit on its books at the beginning of the year, amounting to $1,000,000.

Its capital stock consists of 15,000 shares of preferred stock and 15,000 shares of common stock, both at par value of $100 each.

The stock was originally subscribed and paid in at the average rate of $125 per share, the excess over par being credited to surplus.

In order to absorb the deficit the management suggested changing the capital stock from a par value of $100 each share to no par value with a stated value of $40 per share, the number of shares to remain the same.

Some time before the end of the year you have been engaged to audit the corporation for the current year and at the date of this engagement your opinion has been asked about this proposal. The corporation at this time shows that it has made an earning from operations and it is very evident that the year's operations will show a profit.

A. Discuss the above problem and proposal and offer suggestions.

B. How would you show the changes on the balance-sheet at the close of the year?

Answer any seven of the following nine questions

No. 6 (7 points):

In making an examination of the accounts of a company which had never before employed public accountants, what special points would you need to cover?

No. 7 (7 points):

In the course of your initial examination of the accounts of the Ideal Stores Company, you ascertain that of the substantial amount of accounts payable outstanding at the close of the period, approximately 75% is owing to six creditors. You have requested that you be permitted to confirm the balances owing to these six creditors by communicating with the creditors, but the president of the Stores Company is disinclined to approve your request on the grounds that correspondence in regard to the balances—all of which contain some overdue items—might give rise to demands on the part of the creditors for immediate payment of the overdue items and thereby embarrass the Stores Company.

In the circumstances, what alternative procedure would you adopt in an effort to satisfy yourself that the books show the correct amounts payable to these creditors?

No. 8 (7 points):

Explain how you would proceed to discover irregularities in cash payrolls when it is suspected that the following conditions exist:

(1) Employees released have been continued on payrolls for one or more weeks beyond date of release.

(2) Wages paid to casual labor through paymaster's cash fund have been reimbursed to paymaster twice—once by reimbursement of payments made out of the paymaster's cash fund and again through the usual payroll channels.

(3) Wages not claimed by employees have been misappropriated by the paymaster.

No. 9 (7 points):

In the examination of a coal-mining company in which agents manage the mine operations and sell the coal, for which services they are paid on the basis of tonnage sold, you have been asked to make a particular check of the compensation paid during the year. How would you verify the tonnage sold?

No. 10 (7 points):

A company which you are auditing carries $3,000,000 of insurance on lives of its officers. What verification would you make in connection with this matter and how should transactions for the year and balances at the end of the year be reflected in the accounts?

No. 11 (7 points):

You are requested to prepare an accounting to the probate court for the executor of the Brown Estate. Among the items to be considered are those shown below. State which are properly chargeable to corpus and which to income:

(1) Federal income tax for a fiscal period during the administration of the estate, a large portion of the tax being based upon gain on sale of securities which are part of the corpus.

(2) Real-estate taxes which were a lien upon the property at the time of the decedent's death.

(3) Physician's and nurses' fees for attendance upon the decedent.

(4) Funeral expenses.

(5) Losses on sale of investments owned by decedent and taken over by the executor.

(6) Taxes upon improved property during the administration of the estate.

No. 12 (7 points):

What are the primary purposes of a second bank reconciliation, i.e., a reconciliation of the bank balance as at some date during the auditor's examination subsequent to the reconciliation made as at the balance-sheet date?

No. 13 (7 points):

In making an audit of a small business enterprise you find that all the cash collections are received directly by the bookkeeper who keeps the general ledger and the customers' ledger. There are two assistants in the accounting department who write up the cash, purchases and sales records, and prepare customers' statements. The customers' statements are turned over to the bookkeeper, who looks them over before they are sent out. The bookkeeper has a small imprest fund but to avoid more frequent replenishment of this fund he often cashes checks of employees or outsiders out of the cash collections. These checks are cashed with proper approval and deposited in lieu of the currency used to cash them.

What effect will this situation have on your audit program?

What is the danger of criticizing the present system?

What recommendations would you make for improving the internal control?

No. 14 (7 points):

On returning to the office of the Greenville Company, during August, 1937, to complete an examination of the accounts for the year ended June 30, 1937, you discover that shortly after your previous visit to the company's office, in April, 1937, the Greenville Company received instructions from the parent company (Heavy Chemicals, Inc.) to change its accounting methods in such manner that cash payments heretofore handled through office petty cash and paymaster's and shipping clerk's funds would be entered as of date of payment in the general cashbook. You find also that the cashier has taken advantage of the change of system to suspend the rule that all receipts should be deposited in bank and has utilized miscellaneous cash receipts to meet payments heretofore made through office petty cash and paymaster's and shipping clerk's funds.

How would you modify the usual routine for confirming bank and cash transactions to cover this situation?

Examination in Accounting Theory and Practice

PART I

NOVEMBER 18, 1937, 1:30 P.M. TO 6:30 P.M.

Candidates are required to solve four problems as follows: Problem No. 1, either Problem No. 2 or No. 3, Problem No. 4, either Problem No. 5 or No. 6.

Solve this problem.

No. 1 (40 points):

On December 1, 1936, the Amity Finance Corporation entered into a factoring agreement for the extension of advances or loans to the White Paper Company, to be secured by a general mortgage on paper, pulp and pulpwood inventories, with the exception of pulpwood while in course of woodland operations, such inventories to be marketed in the form of manufactured paper in the regular course of business. The agreement also provided that all sales accounts were to be assigned and transferred to the factor corporation subject to its approval of the credit risk involved; accounts not approved to remain the risk of the borrowing company. Discounts allowed to customers in excess of 1% were to be borne by factor in respect of approved accounts and by the borrower in respect of unapproved accounts.

On January 15, 1937, the factoring corporation rendered the following statement of its account with the borrowing company, for the month of December, 1936:

1936			
December 1	Advances on this date	$250,000	
	Credit for accounts transferred:		
	Credit risks approved		$350,000
	Credit risks not approved		40,000
	Factoring commission @ 1% of approved accounts transferred	3,500	
	Discount provision @ 1% of all accounts transferred	3,900	
December 15	Advances on this date	400,000	
31	Credit for December sales accounts transferred:		
	Credit risks approved		100,000
	Credit risks not approved		25,000
	Factoring commission @ 1% of approved December sales	1,000	
	Discount provision @ 1% on all December sales	1,250	
	Credit for cash remitted on account of doubtful sales accounts which had not been assumed		5,000
December 31	Excess discounts on risks not approved	300	
	Interest on advances, to date	2,250	
	Balance		142,200
		$662,200	$662,200

The White Paper Company continued its control of the customers' accounts and remitted all collections to the factor corporation as indicated by the following analysis of the latter's account to December 31, 1936:

December 1	Advances		$250,000
15	Advances		400,000
31	Customers' collections remitted to factor:		
	Approved risks (less discounts @ 1½%)	$246,250	
	Risks not approved (less discounts @ 2%)	29,400	
	Doubtful accounts—not transferred	5,000	
	Discounts allowed to customers	4,350	
31	Balance	365,000	
		$650,000	$650,000

The following is a trial balance of the accounts of the White Paper Company as at December 31, 1936, reflecting the foregoing balance of $365,000 due to the Amity Finance Corporation and showing the position of the outstanding customers' balances at that date:

	Debits	*Credits*
Cash	$ 50,000	
Trade accounts receivable:		
Assigned to Amity Finance Corporation		
Approved accounts	200,000	
Accounts not approved	35,000	
Other (slow accounts)	15,000	
Inventories—pulp and paper	265,000	
pulpwood at mill	75,000	
logging in progress—woodland operation	95,000	
Mill supplies	80,000	
Cash in closed bank (estimated amount receivable)	3,500	
Land, buildings, plant	2,000,000	
Timberlands	1,350,000	
Plant additions in progress	16,000	
Logging and miscellaneous equipment—net	22,000	
Bond discount and expense	27,000	
Deferred charges—woods operations	13,600	
Unexpired insurance	4,300	
Other deferred charges	2,900	
Notes payable—banks (secured by logging in progress)		$ 47,500
Notes payable—other		16,000
Accounts payable—trade		157,500
Taxes payable—property, stumpage, etc.		23,000
Amity Finance Corporation		365,000
Accrued payrolls		7,000
Accrued bond interest (due November 1, 1936)		30,000
6% First Mortgage Bonds (due November 1, 1947)		1,000,000
Reserve for depreciation—buildings, plant		730,000
Reserve for depletion of timberlands		270,000
Common capital stock 5,000 shares—par 100		500,000
Capital surplus—arising from appreciation of properties		900,000
Earned surplus		208,300
	$4,254,300	$4,254,300

Prepare a balance-sheet of the White Paper Company as at December 31, 1936, after adjusting the account of the Amity Finance Corporation to conform with the statement received from that company, and after setting up reserves for doubtful customers' accounts at the rate of 10% of accounts not approved by the factor corporation and 30% of the slow accounts.

Solve either one of the following two problems.

No. 2 (30 points):

Following is a trial balance of the general ledger of the A B C Manufacturing Company (a co-partnership) at the close of business May 31, 1937, on which date a change in the partnership is contemplated.

A B C Manufacturing Company
Trial Balance, May 31, 1937

	Debit	*Credit*
Cash	$ 22,830	
Accounts receivable	19,135	
Notes receivable	5,400	
Merchandise	52,050	
Machinery and equipment	34,200	
Delivery equipment	3,000	
Drawing account, A	6,000	
Drawing account, B	6,000	
Drawing account, C	6,000	
Life-insurance premiums	18,000	
Reserve for depreciation		$ 27,000
Reserve for doubtful accounts		3,400
Accounts payable		12,750
Expenses payable		975
Capital account, A		62,710
Capital account, B		62,710
Capital account, C		15,000
Sales		235,000
Cash discounts on purchases		980
Recoveries of accounts receivable written off		140
Cash discounts on sales	1,050	
Purchases	65,000	
Factory labor	137,500	
Factory expenses	11,500	
Selling expenses	21,850	
General expenses	11,150	
Total	$420,665	$420,665

The balance in the life-insurance-premiums account represents premiums of $6,000 each paid on three policies, one each on the lives of A, B, and C, respectively. Of this amount $900 was paid during the five months ended May 31, 1937, representing $300 on each of the policies.

Premiums on the policies on the lives of A and B were paid by the firm as a convenience to the partners and the firm as such has no equity in the policies. The policy on the life of C named the firm as beneficiary and the premiums on this policy were regarded as an expense of the business; this policy had a cash surrender value of $5,100 at May 31, 1937. By agreement the partnership turns over to C by transfer to his capital account the policy on his life for the cash surrender value and relinquishes all rights thereunder.

As a preliminary to the change it was agreed to liquidate the partnership. All accounts and expenses payable were to be paid, the partners' drawing accounts closed into their capital accounts and the life-insurance policies turned over to the respective partners in accordance with the aforestated facts.

The books have been kept on a calendar-year basis, having been closed on December 31, 1936. No provision has been made in the accounts since that date for doubtful accounts or for depreciation. The policy of the firm has been to provide for doubtful accounts on the basis of ½% of sales; and to provide for depreciation at the rate of 10% per annum on machinery and equipment and 20% per annum on delivery equipment.

An inventory of raw materials, work in process and finished product was taken as of May 31, 1937, and found to be $63,250. An inventory of supplies taken at the same date comprised: factory supplies $2,050, selling supplies $100 and office supplies $50.

It was further agreed that the books should be closed and the profit or loss transferred to the respective partners' accounts; the partnership agreement provides that profits or losses are to be shared equally.

The notes-receivable account represented a demand note of partner C in favor of the firm. C asked that this note be charged to his capital account and agreed to make good any debit in his capital account resulting from the liquidation.

A offered to purchase the assets and goodwill of the business for $92,000 as follows:

Accounts receivable less reserve	$14,000
Merchandise	50,000
Machinery and equipment	11,000
Delivery equipment	1,000
Supplies	1,000
Goodwill	15,000
Total	$92,000

He offered to make payment by application of the balance in his capital account to the purchase price, the remainder in promissory notes maturing monthly in equal amounts over a period of 15 months.

This offer was accepted; the cash and notes receivable, properly endorsed, were turned over to B and accepted by him in settlement of his capital account.

Required: (1) the journal entries necessary to give effect to the above transactions on the books of the co-partnership and to close these books; (2) the journal entries required to open the books of the sole tradership established by A to carry on the business, and (3) a work sheet on which the foregoing entries are applied to the above May 31, 1937, trial balance.

No. 3 (30 points):

From the following data prepare:

a. Consolidation working-sheet, showing eliminations and adjustments

b. Final consolidated balance-sheet

c. Schedule of dividends in arrears showing amounts applicable to minority interests.

The date on which A acquired capital stock of subsidiary companies was, in each case, the date on which the subsidiary company was organized.

A Company:	
Investment in B Company:	
Common stock 800 shs, 80 pct. int.	$ 80,000
Preferred stock 400 shs, 40 pct. int.	40,000
Investment in C Company:	
Common stock 600 shs, 60 pct. int.	60,000
Reserve against investment in C Company	59,999
Investment in D Company:	
Common stock 1,000 shs, $\frac{2}{3}$ int.	100,000
Preferred stock 800 shs, 80 pct. int.	80,000
Investment in E Company:	
Common stock 1,900 shs, 95 pct. int.	190,000
2nd preferred stock 400 shs, 80 pct. int.	40,000
Account receivable, C Company	300,000
Other assets	69,999
Capital stock	500,000
Earned surplus	400,000
B Company:	
Assets	350,000
Preferred stock, 6 pct. noncumulative	100,000
Common stock	100,000
Earned surplus	150,000
C Company:	
Assets	420,000
Account payable A Company	300,000
Account payable, minority stockholders	200,000
Common stock	100,000
Deficit	180,000
D Company:	
Assets	244,000
Preferred stock, 6 pct. cumulative	100,000
Common stock	150,000
Deficit	6,000
E Company:	
Assets	155,000
1st preferred stock, 6 pct. cumulative	100,000
2nd preferred stock, 6 pct. cumulative	50,000
Common stock	200,000
Deficit	195,000

All the subsidiary companies made a loss during the current year except B Company, which made a profit of $10,000.

Dividends have not been paid on preferred stocks outstanding as follows:

B—for 1 year
D—for 4½ years
E—1st preferred for 1½ years
—2nd preferred for 4 years

The preferred stocks of each subsidiary are callable upon 30 days' notice at $110 per share plus accrued dividends and are entitled upon liquidation to $100 per share plus accrued dividends.

Solve this problem.

No. 4 (20 points):

The following is a balance-sheet of the City of Croix at December 31, 1935:

CURRENT FUND

Assets	
Cash	$ 15,482.34
Taxes receivable:	
Year 1932	1,917.66
Year 1933	7,308.14
Year 1934	8,133.11
Year 1935	123,170.65
Deferred charges:	
Overexpenditures of 1935 appropriations	437.10
Taxes cancelled—1935	850.00
	$ 157,299.00
Liabilities	
Tax revenue notes:	
Year 1933	$ 7,000.00
Year 1934	8,000.00
Year 1935	123,000.00
Accounts payable	17,601.00
Surplus revenue	1,698.00
	$ 157,299.00

CAPITAL FUND

Assets	
Cash	$ 17,810.95
Improvements in progress	39,152.62
Deferred charges to future taxation for cost of completed improvements	25,380.00
	$ 82,343.57

Liabilities		
Serial bonds		$ 26,000.00
Notes payable		49,000.00
Accounts payable		7,343.57
		$ 82,343.57

The governing body of the City adopted the following budget for 1936:

Appropriations		
Department of Public Works	$ 275,450.00	
Department of Revenue and Finance	48,500.00	
Department of Public Safety	535,375.00	
Department of Public Affairs	190,000.00	
Department of Parks and Public Property	60,000.00	
Interest on bonds	3,500.00	
Retirement of bonds	7,000.00	
Interest on notes	4,500.00	
Overexpenditures of 1935 appropriations	437.10	
Taxes cancelled—1935	850.00	
		$1,125,612.10
Anticipated revenues		
General licenses	$ 10,700.00	
Liquor licenses	63,000.00	
Interest on taxes	22,000.00	
City clerks' fees	700.00	
Building permits	2,500.00	
Bureau of health fees	5,400.00	
Police court fines	3,000.00	
	$ 107,300.00	
Amount to be raised by taxation	1,018,312.10	
		$1,125,612.10

The actual amount of taxes levied for the year 1936 was $1,018,603.75.

During the year 1936, improvements in progress costing $30,000 were completed. The notes payable issued to finance the improvements were retired from the proceeds of a serial bond issue which was sold at par.

A statement of receipts and disbursements for the year 1936 follows:

Receipts:	
1932 taxes	$ 1,012.75
1933 taxes	5,475.63
1934 taxes	6,125.47
1935 taxes	115,245.78
1936 taxes	787,375.62
General licenses	10,754.00
Liquor licenses	63,125.00
Interest on taxes	21,900.00
City clerk's fees	725.00

Building permits	$ 2,530.00		
Bureau of health fees	5,350.00		
Police court fines	2,925.00		
Miscellaneous fees	250.00		
Tax revenue notes—1936	215,000.00		
		$1,237,794.25	
Serial bonds		30,000.00	
			$1,267,794.25
Disbursements:			
Department of Public Works		$ 270,680.00	
Department of Revenue and Finance		47,350.00	
Department of Public Safety		525,250.00	
Department of Public Affairs		187,325.00	
Department of Parks and Public Property		59,100.00	
Interest on bonds		3,500.00	
Retirement of bonds		7,000.00	
Interest on notes		4,300.00	
Tax revenue notes—1933		7,000.00	
Tax revenue notes—1934		6,000.00	
Tax revenue notes—1935		114,000.00	
Accounts payable—current fund		16,751.00	
		$1,248,256.00	
Improvements in progress	$ 5,900.00		
Notes payable	30,000.00		
Accounts payable—capital fund	7,343.57		
		43,243.57	
			$1,291,499.57

The following bills applicable to the year 1936 were unpaid at December 31, 1936:

Department of Public Works	$ 4,000.00
Department of Revenue and Finance	1,000.00
Department of Public Safety	9,500.00
Department of Public Affairs	2,000.00
Department of Parks and Public Property	700.00

From the foregoing prepare a work sheet showing (1) the balance sheet at December 31, 1936, (2) the changes in revenue surplus, (3) journal entries and (4) cash transactions.

Solve either one of the following two problems.

No. 5 (10 points):

The X Company is interested in acquiring certain patent rights owned by the Y Company and has made the following offer to the stockholders of the Y Company:

1. The X Company to pay $100 per share for an option to purchase all stock of the Y Company owned by any stockholder within one year from January 1, 1937.
2. The X Company to pay an additional $100 per share to the acceptors of the offer if the option to purchase such shares is exercised.
3. Assets of the Y Company on January 1, 1937, other than patent rights, will be liquidated and the proceeds paid to the old stockholders as their interest may appear. (Old stockholders are those persons who accept this offer, or those who own stock and refuse this offer.)
4. Dividends, other than liquidating dividends, paid during the term of the option shall be applied in reduction of the additional $100 to be paid if the option is exercised.
5. Acceptors of this offer shall deposit their stock holdings with a trustee. The trustee shall receive and hold all dividends applicable to the stock so deposited, except liquidating dividends, pending acceptance or other disposition of the option to purchase such stock.

Stockholders owning 18,000 shares (90%) of the capital stock of the Y Company accepted the above offer effective January 1, 1937, and were paid in cash.

To avoid future complications, the X Company purchased for cash the remaining outstanding shares @ $210 per share on January 15, 1937, and deposited these shares with the trustee.

The following dividends were paid during 1937:

	Liquidating	Other
May 30, 1937	$10 sh.	$20 sh.
October 15, 1937	9 "	10 "

The option was exercised on October 15, 1937, and the Y Company was completely liquidated; the X Company surrendered the capital stock in exchange for patent rights.

Prepare (1) journal entries to record the above transactions on the X Company's books and (2) a statement showing the cost to the X Company of the patent rights acquired.

No. 6 (10 points):

The Brown Company operates a mill, manufacturing a product X. During October and November, 1936, the mill, because of labor troubles, was forced to operate at reduced capacity.

The production and relative unit costs of X for the six months ended December 31, 1936 were as follows:

	Production	
	Units	Unit Cost
July	20,000	$2.20
August	20,000	2.25
September	20,000	2.20
October	2,000	7.50
November	5,000	7.00
December	24,000	2.75

As a result of a labor settlement effective December 1st, the company agreed to pay all its workers a 10% increase in wages. Prior to that date labor cost represented approximately 70% of the total cost of the product. As an additional concession under the labor settlement the company granted a two-weeks' vacation to each employee; these vacations will be taken by the employees on a "staggered" plan, without the employment of any additional labor. No provision has been made in the company's records for this additional concession.

It was determined by the auditor that the expense of police, etc., during the labor difficulties had been properly charged to general expenses.

It is the practice of the company to price its inventory at cost prices established on average bases, predicated upon the production of December, and when the inventory is greater than the production of that month, then the prices are determined retroactively on the basis of the next previous month or months of normal production until a quantity has been obtained equal to the inventory on hand. The inventory of X at December 31, 1936, was 50,000 units.

At what prices should the company's inventory be valued? Show your computations.

Examination in Commercial Law

NOVEMBER 19, 1937, 9 A.M. TO 12:30 A.M.

Reasons must be stated for each answer. Whenever practicable give the answer first and then state reasons. Answers will be graded according to the applicant's evident knowledge of the legal principles involved in the question rather than on his conclusions.

GROUP I

Answer all questions in this group

No. 1 (10 points):

A stationery company wrote to a certified public accountant that "We have quite a few pads of slightly defective but completely usable analysis paper which we now offer you at 45 cents per pad." The accountant wrote in reply: "I accept your offer and I will take one dozen pads." Do these two letters constitute a valid contract?

No. 2 (10 points):

If you were consulted by an attorney at law who was about to draw a partnership contract to be executed by three practising public accountants, what provisions would you recommend for inclusion in the contract?

No. 3 (10 points):

On October 14, 1937, X steals two legally valid negotiable notes payable to bearer (one due October 21, 1937, and one due November 22, 1937) and corporate bearer bonds with the November 1, 1937, coupons attached. On October 22, 1937, X sells both notes and the bonds to Y who pays full value and has no knowledge, either actual or constructive, of the theft by X.

(a) Can Y collect from the maker on either or both of these notes?

(b) Can Y collect from the corporation on the November 1, 1937, coupons?

No. 4 (10 points):

(a) What is meant by the maxim *caveat emptor?*

(b) State briefly the facts of a transaction to which it would be applied.

No. 5 (10 points):

X, a minor, made a written contract with Y, an adult, whereby Y agreed to sell to X certain merchandise not constituting necessaries. Y failed to deliver and X sued Y for breach of the contract. As a defence, Y pleaded the infancy of X. Is this a valid defense?

GROUP II

Answer any five questions in this group. No credit will be given for additional answers, and if more are submitted only the first five will be considered.

No. 6 (10 points):

(a) X, who is 45 years old, leases from a corporation an entire building for a term of 99 years, the lease binding X's estate. Is this lease held by X personal property or real property?

(b) What elements or factors must be found to make a transaction a gift of personal property?

(c) What elements or factors must be found to constitute adverse possession?

(d) Can title to personal property be acquired by adverse possession?

No. 7 (10 points):

(a) In a state where a person becomes of age at 21 years, is a minor 20 years old legally qualified to be a principal and as such to appoint an agent?

(b) In such a state, is a minor 20 years old legally qualified to act as agent for another person as principal?

(c) What elements or factors must be found to constitute an agency by ratification?

(d) Can a corporation ratify an act by a promoter prior to incorporation?

(e) Can one whose signature has been forged ratify the act of the forger?

No. 8 (10 points):

In the event of one or more but not all of the members of a partnership being adjudged bankrupt, can the partnership property be administered in bankruptcy? If not, how will it be administered?

No. 9 (10 points):

X was the secretary of a corporation which had been in existence for a number of years and he was duly authorized to solicit subscriptions to unissued capital stock the par value of which was $100 per share. X induced Y to subscribe on July 1, 1937, for 100 shares at a total price of $50 per share by telling Y (1) that the corporation's gross sales for July, 1937, were certain to exceed $20,000, (2) that the certificate of incorporation expressly empowered the corporation to conduct certain activities, and (3) that Y would not be liable to the corporation or to any other person or corporation for any amount in excess of the subscription price of $50 per share. Y agreed to pay for this stock on September 1, 1937. On August 16, 1937, Y ascertained that the gross sales for July, 1937, had been slightly less than $5,000 and that the certificate of incorporation did not grant the corporate power stated by X, and Y was informed by his attorney that he would be liable for an additional $50 per share. Can Y immediately cancel his subscription agreement?

No. 10 (10 points):

In preparing a trustee's accounting, what tests would you apply to determine whether a dividend duly declared by a corporation was an ordinary dividend to be credited to income, or an extraordinary dividend subject possibly to apportionment between income and principal?

No. 11 (10 points):

George Griffin was an accommodation endorser on a negotiable promissory note, and he died prior to the maturity of the note. On the day when this note became due, Griffin's executor, at the payee's insistence and without receiving consideration therefor, endorsed a renewal note as follows: Estate of George Griffin, deceased, by Edward Patterson, Executor.

(a) Did this endorsement discharge the estate from liability upon the original note?

(b) Did the executor become personally liable by this endorsement?

No. 12 (10 points):

The garnishee laws of a state entitle a judgment creditor to 10% of the income of his judgment debtor and under those laws a garnishee execution, duly issued on a $50,000 judgment, ordered a life-insurance company to deduct and pay to the creditor 10% of the income from a trust fund held by it. This trust fund consisted of the proceeds of a life-insurance policy, $40,000, which the policy provided should be held by the company at 3% interest and paid to the judgment debtor as beneficiary in equal monthly instalments of $500 as long as said proceeds with interest thereon should last.

(a) Is the judgment creditor entitled to 10% of the total of each instalment?

(b) If not, how would you determine the amount to which he is entitled, and would that amount remain constant, increase, or decrease up to and including the last $500 instalment?

Examination in Accounting Theory and Practice

PART II

NOVEMBER 19, 1937, 1:30 P.M. TO 6:30 P.M.

Candidates must solve four problems as follows: Problem No. 1; No. 2; either No. 3 or No. 4; problem No. 5.

Solve the following two problems

No. 1 (40 points):

The Miracle Chemical Company manufactures two products, Mirachem and Corim. Both are made from the same raw materials in the same proportions. In addition to a difference in packaging, Corim is processed in Department B and Mirachem is not.

The plant of the company is divided into four departments, A, B, C, and D. Materials suffer a shrinkage of 16⅔% in Department A, a shrinkage of 20% in Department B, a shrinkage of 10% in Department C, and no shrinkage in Department D.

The materials are mixed in Department A at a cost for labor and overhead of 10¢ per lb. of finished mixture. The materials used are X which costs $1.10 per lb., Y which costs 15¢ per lb., and Z which costs 40¢ per lb. They are mixed in the proportion of one pound X to eight pounds Y to three pounds Z, comprising the unit for calculation. Assume that materials and packages are purchased in quantities just sufficient to cover the sales requirements.

Labor and overhead in Department B amount to 9¢ per lb. of material delivered to the department.

In Department C an amount of water equal to the weight of the material received is added. Labor and expenses including water in this department amount to 5¢ per lb. of material finished.

Department D is the packaging department. Labor and expenses exclusive of the packages cost 5¢ per lb. of Mirachem handled and 7½¢ per lb. of Corim handled. Packages for Corim holding four ounces of the finished product cost 5¢. Packages for Mirachem of the same size cost 2½¢. Corim is sold at 50¢ and Mirachem at 25¢ a package and the total dollar sales are equally divided between the two products.

General and administrative expenses, including advertising, amount to $90,000 a year.

From the foregoing data prepare a statement of profit and loss in the usual columnar form, showing an aggregate net operating profit of 20% on the sales; also showing for each product the number of packages sold and the gross profit; and for each product and each department the materials and supplies purchased and used as well as the labor and expenses.

No. 2 (25 points):

From the following data, prepare a balance-sheet of the XYZ Company as at December 31, 1936: submit all work sheets.

TRIAL BALANCE AFTER CLOSING DECEMBER 31, 1935

	Debits	*Credits*
Cash	$ 75,000	
Dividends receivable ($2 per share on 1,500 B)	3,000	
Other accounts receivable	1,000	
Marketable securities at average cost detailed below	865,000	
Deferred charges	1,000	
Furniture and fixtures	10,000	

Reserve and depreciation of furniture and fixtures		$ 6,000
Accounts payable and accrued expenses		2,000
Reserve for estimated Federal income taxes—1935		10,000
Capital stock { authorized—100,000 shares @ $10 par; issued and outstanding—50,000 shares		500,000
Capital surplus		300,000
Earned surplus		137,000
	$955,000	$955,000

MARKETABLE SECURITIES ON HAND DECEMBER 31, 1935

Shares	Security	Average Cost
1,000	A	$ 90,000
1,500	B	120,000
600	C	60,000
1,500	D	95,000
1,200	E	85,000
1,000	F	130,000
800	G	85,000
1,000	H	70,000
2,000	I	130,000
		$865,000

SECURITY TRANSACTIONS—1936

Purchases

		Shares	Cost			Shares	Cost
March	20	200 A	$ 20,000	July	15	300 K	$ 40,000
April	15	500 B	50,000	July	25	200 G	20,000
April	25	200 J	15,000	August	15	200 G	25,000
May	10	300 J	25,000	September	15	1,000 K	90,000

Sales

		Shares	Selling Price			Shares	Selling Price
January	15	200 A	$ 19,000	July	20	500 A	$ 50,000
March	10	200 F	30,000	August	20	1,000 H	30,000
April	10	1,200 E	110,000	September	15	1,000 B	125,000
June	15	300 F	50,000				

OTHER DATA

Purchased on December 15, 1936: 200 shares of XYZ Company for $3,000.

Cash dividends received—1936: A $5,000; B $12,000; D $4,000; F $6,000; G $5,000; I $9,000; J $1,000.

Accounts receivable collected and debts paid.

Stock dividend received June 15, 1936: H—100%.

Expenses accrued and paid—1936: $20,000.

Federal capital-stock tax paid July 20, 1936: $1,000.

Dividends paid December 10, 1936: $2 per share.
Purchased December 31, 1936, for delivery and payment January 2, 1937: 200 shares G $25,000.
Dividends declared in 1936 payable in 1937:
H at each $1 per share to stockholders of record December, 1936
D at each $1 per share to stockholders of record January 2, 1937
Market value of marketable securities at December 31, 1936: $950,000.
Federal income taxes paid for the year 1935: $9,000.
Federal income taxes for the year 1936 estimated at $12,000.

Solve one of the following two problems

No. 3 (20 points):

From the following data extracted from the accounts of the Automobile Finance Company, for the year 1936, prepare a statement of the corrections that you would consider it necessary to make, based on the experience of the company in that year, in order to place the reserve for unearned income, etc.—the only reserve account carried by the company—on a conservative basis. (The interest rate used by the Finance Company was 6%):

Volume of business transacted in 1936		$2,400,000
Total income for 1936		144,000
Provision for collection expenses on 1936 business		36,000
Provision for losses on 1936 business		12,000
Notes receivable—outstanding at December 31, 1936:		
Past due	$ 20,000	
Due 1937:		
January	140,000	
February	130,000	
March	120,000	
April	110,000	
May	100,000	
June	90,000	
July	80,000	
August	80,000	
September	70,000	
October	60,000	
November	50,000	
December	50,000	
Due 1938:		
January	40,000	
February	30,000	
March	30,000	
April	20,000	
May	20,000	
June	10,000	
Total		1,250,000
Reserve for unearned income, etc.		25,000

No. 4 (20 points):

You have been handed a circular letter received by a common stockholder of a company wherein the income from operations of the company for the past year is shown as materially greater than for the year before. The only information given is as follows:

> For the year 1936 the gross income of the company was \$4,700,000, and after deducting \$4,000,000 for cost of goods sold, general, selling and administrative expenses, and \$250,000 for depreciation, interest and federal income taxes, the net profit was stated to be \$450,000, which was equivalent to 24 cents per share on the outstanding common stock, after paying the 6% dividend on preferred stock.
>
> The net income for 1935 was \$196,000 which was equal to 2 cents per share on the outstanding common stock after paying the preferred dividend.
>
> The stockholder recalls that the only stock changes during the two years were issues on January 1, 1936, of 200,000 shares common, and of \$500,000 preferred.

In view of the large difference in the stated profit per share from that of the previous year, you are asked to advise if the reported result appears reasonable.

Prepare a statement for the stockholder explaining and reconciling the figures of the two years, showing number of shares of common stock and amount of preferred stock outstanding.

Solve the following problem

No. 5 (15 points):

John Smith borrowed 2,000,000 Francs in Paris for 150 days at 3%, interest in the United States being at 5% (interest payable on due date of loan). The rate of exchange was \$.06 on the date the loan was made and was \$.061 on the date of repayment. Commission on purchase or sale of exchange was 1/20% for each transaction. The cable charge for each transfer of funds was \$20.

How much did Mr. Smith save or lose by borrowing abroad at the lower interest rate? Submit the work sheet supporting your answer.