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 May 11 and 12, 1939.]

EXAMINATION IN AUDITING

May 11, 1939, 9 a.m. to 12:30 p.m.

[*The candidate must answer all questions.*]

No. 1 (5 points):

State for each case the conditions under which an auditor may accept the valuation of the inventory of a manufacturing or trading concern, for many years consistently priced on one of the following bases, viz.: (a) cost, (b) market, (c) the lower of cost or market, (d) sales value, or (e) standard cost. In each instance the auditor himself has verified the inventory by thorough tests of quantities, prices, and clerical accuracy.

No. 2 (5 points):

Should the footings of the cash, purchase and sales records and the postings of the respective totals to the general ledger be checked or tested as part of an examination of the books of account? Why? Give one or more examples of possible irregularities that might be detected by these checks or tests.

No. 3 (5 points):

The Smith Manufacturing Company buys all its raw material from the Jones Company and pays upon receipt of the goods. In December, 1937, the Jones Company required extra cash to take advantage of favorable market conditions and borrowed $20,000 from the Smith Company on its negotiable promissory note maturing June 1, 1938. By agreement apart from the note, payments were to be made on the principal of the note by application of billings for raw material successively supplied to the Smith Company in 1938. The Smith Company discounted the note at the bank and turned over the cash proceeds to the Jones Company. No entries recording the transactions were made on the books of the Smith Company. In preparing financial statements of the Smith Company as at December 31, 1937, how should the facts relating to the note be shown on the company's balance-sheet? State your reasons.

No. 4 (5 points):

Give a convincing reason why dividends received on treasury stock should not be shown as income. Mention exceptions to this rule.

No. 5 (5 points):

Where and how are the terms "vouching" and "vouchering" used and what is their meaning?

No. 6 (10 points):

How can the auditor assure himself, when examining the client's accounts for the first time, that there are no encumbrances upon the assets other than those disclosed by the accounts themselves and by the officers' certificates? State what further measures he should take in this connection concerning (a) real estate and equipment, (b) merchandise, (c) accounts receivable.

No. 7 (10 points):

A wholesale concern makes advances to its salesmen from petty cash. All these advances are first approved by the sales manager. The unused portions of the advances are taken back into the petty-cash fund. The latter is periodically reimbursed from general cash for the net amount paid out and the expenditures of the salesmen are charged to "travel and entertainment expenses." The petty cashier checks the salesmen's expense statements and keeps them on file.

(a) What is the weak point of this procedure and what is the principle involved that has not been observed?

(b) Would the control be adequate if the salesmen's expense statements were to be attached to the petty expense summary, thus to become a part of the reimbursement voucher after being subjected to the vouchering department's or staff auditor's scrutiny? Give reasons for your opinion.

(c) If the control would not be adequate, state specifically how the advances and expenditures can be satisfactorily controlled and explain the internal accounting procedure.

No. 8 (10 points):

Briefly describe a practical method of filing from year to year the auditor's work papers in connection with the annual audits of a large industrial concern—from the report and accounts down to the detailed schedules and other papers and memoranda.

No. 9 (10 points):

The department of internal revenue has disallowed the deduction from taxable income of:

1. The expenditure of $200 to rehabilitate a truck that had been completely written off.
2. The amount of $100 written off in connection with another truck. This truck had been retired from service and turned in as a part of the purchase price of a new truck. After deducting the depreciation reserve and the trade-in allowance the above $100 remained as part of the debit balance in automobile account and was written off as a loss.

Explain why these deductions were disallowed and indicate what entries should be made to give effect to the decision.

No. 10 (15 points):

In a large concern the payment of purchase invoices is ostensibly under close control. The invoices pass through the usual routine of verification by the purchase, receiving, and accounting divisions. They accompany the checks when presented to responsible officers for signature and countersignature, and all invoices and memoranda pertaining to a payment are filed together. Nevertheless, it occasionally happens that an invoice is paid twice. Describe various conditions under which this could take place and how they may be remedied.

No. 11 (20 points):

Briefly define the meaning of each of the terms "voucher," "voucher check," "voucher index," "voucher record" and describe, in not over 400 words, a modern accounts payable voucher system, its operation and advantages.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

May 11, 1939, 1:30 p.m. to 7:30 p.m.

[*The candidate must solve all problems.*]

No. 1 (10 points):

Under the terms of the will of J. J. Bullard, who died in 1935, the beneficiaries were:

Mary Bullard, widow of testator, who was left a special bequest of $50,000 payable immediately, and in addition a life interest in one half of the residuary estate, with the right of appointment.

Kathlyn Bullard, his daughter, who was left one fourth of the residuary estate. One half of this was left outright and the other half to remain in trust, with the right of appointment.

Jenny Bullard, his daughter, who was left a life interest in one eighth of the residuary estate, with the right of appointment.

John Bullard, his son, who was also left a one eighth interest in the residuary estate, to be paid to him outright.

The testator specified that, on account of the unsatisfactory market conditions, the trustees have the power and right to defer liquidation of any of the assets until, in their opinion, conditions are favorable and may, in their discretion, make intermediate distributions of principal from the funds so realized to the beneficiaries who are entitled thereto. The income from the estate was to be distributed annually in the proportion of the beneficiaries' interests.

On December 31, 1937, the following advances were made on account of principal:

Kathlyn Bullard	$150,000
John Bullard	100,000

but the special bequest to Mary Bullard had not yet been paid.

The trustees rendered their first accounting to the surrogate as at December 31, 1937, on which date all income, after paying therefrom all expenses applicable to income, was paid to the beneficiaries.

The surrogate's decree on the accounting of December 31, 1937, specified that (1) in considering the distribution of future income, all intermediary payments of principal should be treated as advances to the beneficiaries, and (2) in order to make a fair and equitable division of income, interest at six per cent per annum should be charged and credited.

The income of the year 1938 amounted to $450,000 after all expenses applicable to income had been paid. No further distribution of principal had taken place.

Prepare a statement showing the amounts payable to each beneficiary on December 31, 1938.

No. 2 (20 points):

The Universal Patent Corporation acquired 700 shares of the capital stock of the General Development Company as follows:

Date acquired	*No. of shares*	*Purchase price*
January 2, 1938	600	$300,000
June 30, 1938	100	46,000

The audited balance-sheets of the General Development Company are given here below:

Assets	Jan. 1 1938	June 30 1938	Dec. 31 1938
Cash	$ 30,000	$ 78,000	$ 40,000
Royalties receivable	60,000	65,000	50,000
Patent	60,000	57,000	54,000
	$ 150,000	$200,000	$144,000
Liabilities			
Federal income tax payable	$ 20,000	$ 19,000	$ 25,000
Sundry liabilities	5,000	6,000	4,000
Capital stock—1,000 shares	100,000	100,000	100,000
Earned surplus	25,000	75,000	15,000
	$ 150,000	$200,000	$ 144,000

Adequate provision was made for amortization of the patent by a straight-line method and for all liabilities, including taxes, and no undistributed-profits tax is payable. On December 30, 1938, a dividend of $150,000 had been paid.

On that same date the shareholders of the General Development Company ordered the liquidation of the company as at the close of December 31, 1938. The shareholders were to receive a pro-rata assignment of their interest in the patent on January 2, 1939. The collection of royalties receivable, payment of liabilities, and distribution of available cash was to be effected not later than February 15, 1939, and $1,000 was appropriated for the estimated expenses in the period of liquidation.

From the foregoing information, prepare the entries which the Universal Patent Corporation should make to record the amortized cost of its interest in the patent on the date of assignment.

No. 3 (35 points):

A governmental authority was constituted about July 1, 1937, to carry out certain recreational activities for which the authority was to buy or construct the equipment.

It was decided that the accounts of the authority will show budgetary estimates as well as actual income and expenditures in an approved manner, and that the transactions will be recorded in the following funds:

General operating fund
Working capital fund
Sinking fund for redemption of bonds
Property fund

From the following information, prepare a columnar work sheet recording the transactions of the authority so as to show the asset and liability and budgetary accounts for the year ended June 30, 1938:

(1) An advance of $50,000 was made by the government creating the authority to finance the initial construction and activities, to be repaid out of operating revenues.

(2) From the working capital fund thus created, $10,000 was transferred to the general fund for current operating expenses until revenues could be realized.

(3) A budget of recreational activities for the year was adopted as follows:

Revenues

Licenses	$ 50,000	
Fees	100,000	
Sales	30,000	
Miscellaneous	10,000	$190,000

Expenditures

Administration	$ 10,000	
Bathing pavilion	65,000	
Boating	25,000	
Park maintenance	54,000	
Interest on bonds	6,000	
Sinking fund requirements	20,000	$180,000

(4) Purchases of supplies were made for central stores to the amount of $36,000 and paid in full.

(5) A bond issue of $200,000 for improvements was authorized as of July 1, 1937, bearing interest at 3 per cent per annum, payable semi-annually. It was disposed of on August 1st at par and accrued interest of $500.

(6) Contracts amounting to $165,000 were let for improvements. Work was completed and contracts paid to extent of $156,000, which included $1,000 extras, leaving $10,000 in progress on June 30, 1938.

(7) Additional construction work was supplied through the working-capital fund to the extent of $34,000, which included $18,000 labor paid in cash, $14,000 material from stores at cost, and $2,000 overhead. The working capital fund was reimbursed in full for this service.

(8) Other services (labor only) supplied to authority activities and paid for by the working-capital fund were as follows, including 10 per cent or $920 for overhead:

Bathing pavilion	$ 3,300	
Boating	1,100	
Park maintenance	5,720	$10,120

Of the above, $2,200 for park maintenance was incomplete and not billed as of June 30, 1938. Otherwise, reimbursement to the working-capital fund was completed.

(9) Revenues collected during the year were as follows:

Licenses	$ 48,500	
Fees	101,400	
Sales	29,200	
Miscellaneous	9,400	$188,500

In addition there were $1,600 of licenses billed but not collected, on which possible losses should not exceed 20 per cent.

Of the fees collected, it was necessary to refund $210.

Of the licenses collected, $500 represented advance payments on account of the following year.

(10) Supplies were issued to authority departments by the central stores as follows, the figures in each case including 10 per cent or a total of $1,050 for working-capital-fund overhead:

Administration	$ 330	
Bathing pavilion	2,640	
Boating	1,650	
Park maintenance	6,930	$11,550

Transfers were made to the working capital fund to the amount of $10,600 on account of these items.

(11) Contracts and orders issued during the year for operating expenses totaled

$83,000. These were liquidated to the extent of $81,160, leaving $1,200 for bathing pavilion, and $640 for boating, or a total of $1,840 outstanding at June 30th.

(12) Vouchers approved during the year for payrolls, invoices, and miscellaneous, including those covering contracts and orders liquidated, as well as other items, were as follows:

Administration	$ 9,450	
Bathing pavilion	59,160	
Boating	21,600	
Park maintenance	41,000	
Interest	6,000	$137,210

Treasury warrants were issued and paid in settlement of these items to the amount of $135,610.

(13) Transfer was made to the sinking fund for $18,000 of the amount due it from the general fund, leaving the remainder as still owing. Securities costing $18,000 were purchased for this fund, and income thereon was realized to the amount of $300. Among the securities purchased were $5,000 bonds of the authority, which were immediately retired.

(14) The sum of $5,000 was repaid to the working-capital fund on the advance made to the general fund.

(15) Purchases of office and general equipment to the amount of $20,000 were made from the working-capital fund. This equipment is to be written off by charges to overhead at the rate of 5 per cent per year, beginning with the current year.

(16) Overhead expense of the working-capital fund paid for the year was $2,600. The physical inventory of stores at the end of the year was $12,300. Stores and overhead surplus were carried to the surplus account of the fund. The sum of $1,000 was repaid to the central government to apply on the advance made to the authority.

(17) Among the invoices paid during the year from the general fund were items totaling $16,540 for park maintenance equipment.

No. 4 (35 points):

From the following trial balance of the Household Furnishing Corporation and accompanying data, prepare the balance-sheet of December 31, 1937, and the profit-and-loss account for the year ended on that date:

TRIAL BALANCE (per books)
December 31, 1937

	Dr.	*Cr.*
Cash	$ 83,000.00	
Instalment accounts receivable	1,078,000.00	
Sundry advances	7,000.00	
Reserve for bad debts—January 1, 1937		$ 27,000.00
Reserve for collection expenses—January 1, 1937		14,000.00
Merchandise inventory—December 31, 1937	160,000.00	
Furniture and fixtures	15,000.00	
Delivery equipment	12,000.00	
Reserve for depreciation—December 31, 1937		6,300.00
Improvements to leaseholds	8,600.00	
Reserve for amortization—December 31, 1937		3,100.00
Prepaid expenses	4,900.00	
Accounts payable		92,400.00
Reserve for contingencies		75,000.00
Capital stock—8,000 shares of $100 each		800,000.00
Earned surplus		358,318.75
Sales—instalment		1,068,750.00
Sales—cash		56,250.00
Cost of sales—instalment	567,506.25	
Cost of sales—cash	37,662.50	
Selling and general expenses	367,450.00	
Dividends paid	160,000.00	
	$2,501,118.75	$2,501,118.75

The corporation sells household goods on the instalment plan. Payments are deferred over periods ranging from 12 to 18 months. No carrying charges are made, the selling price being the full amount payable by the customer.

The entire profit is taken up as income of the year in which the sales are made, and federal income taxes are provided on that basis. They are paid, however, on the instalment basis (see note 2), and the unpaid balance, representing taxes on the unrealized profit in the instalment accounts receivable, is carried as a reserve for contingencies.

At the end of each year the instalment accounts are evaluated so that the reserve for doubtful accounts may be adjusted to correspond with this appraisal. The reserve for collection expenses must at that time be adjusted to an amount that equals 1½ per cent of the instalment accounts receivable after deducting the reserve for doubtful debts.

Upon examination of the books the following additional information has become available:

Instalment accounts receivable amounting to $18,500 are considered worthless and should be written off. The management further estimates that a reserve of $28,500 will be adequate to provide for additional losses on account of doubtful customers' balances. The auditor, however, believes that this reserve may not be adequate, but he cannot induce the management to provide more.

It was also found that the reserve for collection expenses at the beginning of the year had not been correctly computed.

During the year $5,100 had been written off for losses on repossessed goods, as follows:

On sales in 1934	$ 3,500
" " " 1935	1,500
" " " 1936	800
" " " 1937	600
	$ 6,400
Value of repossessed goods	1,300
Written off, as above	$ 5,100

The $18,500 of worthless accounts represent sales made in the following years:

1934	$12,000
1935	3,000
1936	2,000
1937	1,500
Together, as above	$18,500

The collections during the year applied to instalment sales as follows:

1934	$ 3,600
1935	58,000
1936	210,000
1937	820,000
	$1,091,600

The previous years' percentages of gross profit were:

1934	49%
1935	48%
1936	46.5%

It may be assumed that no excess-profit tax is payable.

NOTES

(1) The normal tax computation for the year 1937 is as follows:

On the first	$ 2,000	at the rate of 8% or	$ 160
On the next	13,000	" " " " 11%	1,430
On the next	25,000	" " " " 13%	3,250
	$40,000		$ 4,840

On income in excess of $40,000 at the rate of 15%

(2) According to section 44 of the income-tax law:

". . . a person who regularly sells . . . on the instalment plan may return as income therefrom in any taxable year that proportion of the instalment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price."

EXAMINATION IN COMMERCIAL LAW

May 12, 1939, 9 a.m. to 12:30 p.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):

X, a dealer, makes numerous sales to Y, and at the end of each calendar month X sends Y an itemized statement. Some but not all of the charges by X bear interest. Because of unsettled disputes, a few of the items listed on the statement of April 30, 1939, had been billed for over five years. Y is about to make a payment on account. Has Y the right to compel X to apply this payment to items of principal or interest specified by Y, at the time of payment? Or has X the right to apply this payment as X desires, (a) if Y specifies the application, (b) if Y does not specify? If X has a right to apply the payment as X desires, within what time should he exercise it, and what notice if any should X give Y concerning the application made by X?

No. 2 (10 points):

F, G, and H on March 15, 1939, agree orally to begin business in corporate form on May 1, 1939, and they retain a lawyer who prepares the certificate of incorporation which they execute on April 3, 1939. On April 10, 1939, F takes this certificate for delivery to the lawyer, but he inadvertently fails to deliver it. During the month of April, 1939, G and H sign a lease for office space and make various other contracts, all in the name of the proposed corporation. The lawyer inferred that the matter of the proposed incorporation had been dropped and he did nothing further with respect to it. Can F, G, and H be held personally liable on the lease and the other contracts made in April? If so, would they be held jointly, severally, or jointly and severally liable?

No. 3 (10 points):

When and in what circumstances may a general agent renounce his agency and terminate his relationship with his principal without incurring liability to the principal?

No. 4 (10 points):

Black made and delivered a legally valid promissory note, entirely in his own handwriting, payable at "No. 22 Mira Vista Ave.," which was his residence. The note was transferred several times by endorsement, and some one without authority added "People's Trust Co." in printed characters on the face of the note directly under the handwritten designated place of payment. Thereafter, but prior to maturity, Brown acquired the note by purchase for value and without actual knowledge of the alteration. At maturity, Brown presented the note at the Peoples Trust Company, which was not at the stated address, and the note was not paid. Can Brown recover from Black on this note?

No. 5 (10 points):

Define partnership and state and explain briefly the more important legal characteristics of one.

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):

X purchases on credit an automobile, for which the cash price was $2,100, and agrees to pay $2,400 for it at a date six months after the date of purchase. He makes a payment of $100 on account and takes possession of the automobile. On the assumption that the legal rate of interest was 6%, can X successfully attack the validity of the contract on the ground of usury?

No. 7 (10 points):

A collection agency, incorporated under the laws of Missouri, makes a written contract in New York with a New York client, which recites that the collection agency "has executed and attested these presents at the City of St. Louis, to be effective from the date the acceptance is received at the office of the company at St. Louis, Mo." The agency has an active bank account in New York and it maintains an office there where it has a staff of salesmen. It is listed in building and telephone directories in New York and it deposited the client's check in its New York bank account. The agency had not qualified, as a foreign corporation, to do business in New York. Would it be permitted to maintain an action against its client in the New York courts?

No. 8 (10 points):

State and illustrate by brief examples the difference between a contract of sale and a contract for work, labor, and services, and explain the importance, legally, of differentiating between them.

No. 9 (10 points):

A testamentary trustee received from the executor of testator's will shares of stock in a corporation and subsequently he purchased additional shares of the same stock. Thereafter the corporation issued and the trustee received rights to subscribe to new stock of the same character. What principles and rules of law should the trustee have in mind when he decides what to do about these rights?

No. 10 (10 points):

Define purchase-money mortgage and give a brief example showing circumstances in which one normally would be given. Which party in the sale becomes the mortgagee? What, briefly, are the rights and remedies of each party?

No. 11 (10 points):

During a time of financial stress, the Clearing House Committee in a certain city promised a banker in that city and the United States Comptroller of the Currency that, if the banker would accept the presidency of a certain bank, the Committee would protect the depositors of that bank and prevent the bank's failure.

(a) What is the relation between a bank and its depositors?
(b) Was the above promise subject to the statute of frauds?
(c) If your answer to (b) is in the affirmative, what provision in said statute applied to this promise?

No. 12 (10 points):

A sole proprietor is occupying office space under a legally valid lease which will not expire until three months from today. He is in arrears for four months' rent and is about to vacate the premises. He is in arrears also for the rent of two rooms which he occupies without a lease in a hotel. What principles of law are involved in determining his right, upon immediately vacating both premises, to remove all of his property therefrom?

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

May 12, 1939, 1:30 p.m. to 7:30 p.m.

[*The candidate must solve all problems.*]

No. 1 (10 points):

An investment trust, whose stock is listed on the New York Stock Exchange, has requested an opinion concerning the proper record of dividends received or receivable as follows:

(1) 1,000 shares of common stock of X Manufacturing were received as a dividend on an investment in common stock of Y Corporation. The value of the shares at time of receipt, based on stock-market quotation, was $100,000. The shares were carried on the books of the paying corporation at a cost of $50 per share and the dividend was charged to surplus at that cost.

(2) The trust owns 1,000 shares of preferred stock and 500 shares of common stock of A

Corporation and has received as a preferred dividend 100 additional shares of common stock of A Corporation.

(3) A dividend is receivable on a common-stock investment payable at the option of the shareholder in cash or in preferred stock of the paying company, similar preferred stock being outstanding and listed on the stock exchange. The trust has decided to take stock.

Give your opinion how in each instance the receipt of the above dividends should be recorded.

NOTE.—Investment trusts, when listing their stock on the New York Stock Exchange, agree with the exchange as follows:

"Not itself, and not to permit any subsidiary, directly or indirectly controlled, to take up as income stock dividends received at an amount greater than that charged against earnings, earned surplus or both of them by the issuing company in relation thereto."

No. 2 (15 points):

On July 1, 1937, the merchandise inventory of the glove department of a department store aggregated $90,600 at retail and $54,360 at cost. During the following six months the purchases and sales were as follows:

	Purchases			
Month	Cost	Retail Price	Original Mark-up	Net Sales
July	$ 24,300	$ 40,200	$ 15,900	$ 24,900
August	31,500	55,800	24,300	30,500
September	43,000	75,900	32,900	38,200
October	35,200	60,000	24,800	55,300
November	17,300	30,300	13,000	58,700
December	9,500	15,700	6,200	60,900
	$160,800	$277,900	$117,100	$268,500

During these six months the following reductions were made in the retail price:

1. To facilitate disposal of over stock	$ 4,000
2. In connection with odd lots	2,500
3. To meet competitive prices	3,000
4. Miscellaneous	2,000
Together	$11,500

In addition to the above mark-downs, the selling price of certain merchandise was reduced in connection with a special store-wide sale held annually in October of each year. For the duration of the sale, the selling price of a lot of merchandise consisting of 300 dozen pair of a nationally advertised brand of gloves was reduced from $5.00 per pair to $4.25 per pair. At the conclusion of the special sales period it was found that 26 dozen pair remained unsold and the selling price thereof was restored to $5.00 per pair.

During the season the selling price of a special lot of imported gloves which proved to be unusually popular was increased from the original selling price of $6.00 per pair to $7.50 per pair. This additional mark-up applied to 500 dozen pair of gloves. Later in the season the additional mark-up of $1.50 was canceled on 75 dozen pair of gloves of a certain color which were not moving as fast as the remainder of the line and the price reduced to the original price of $6.00 per pair.

A physical inventory taken at the close of business December 31, 1937, aggregated $94,500 at retail. The physical inventory at retail was found to be unusually close to the book inventory and did not show the normal expected shrinkage. Investigation revealed that a lot of 50 dozen pair of gloves received in the last few days of the year had not been included in the purchases recorded in the stock records because the invoice had not been received until after the close of the year. This lot of 50 dozen pair of gloves was purchased at a cost of $3.75 per pair and marked to sell at $6.00 per pair. Some of the gloves included in this lot had been sold before the close of the year and were not included in the inventory.

From the above information compute by use of the retail inventory method:

(a) The amount of the stock shortage at retail.
(b) The value at which the closing inventory of the glove department should be carried on the balance-sheet.
(c) The cost of sales for the six months ended December 31, 1937.

In the solution carry percentages to 2 decimal places.

No. 3 (35 points):

Company A and Company B are engaged in the production and sale of crude oil. On January 1, 1938, Company A acquired from Company B a twenty years' leasehold on a certain undeveloped property on the following terms:

1. Of the oil produced, 12½ per cent is to be delivered to Company B as royalty.
2. On the remaining 87½ per cent Company A is to pay Company B 25 cents per barrel until the total so paid has aggregated $700,000. The latter sum is understood to be the purchase price of the lease and must be paid unless the geologists' estimate of the total oil underground capable of being produced is less than 3,200,000 barrels. In that event the purchase price will be proportionately reduced.
3. To ensure development of the property, Company A is to keep one string of drilling tools in continuous operation until January 1, 1948, or pay a penalty to Company B for idle periods, calculated on the basis of $50,000 for a whole year's cessation of drilling operations.
4. Company A is to pay the land rentals which amount to $75,000 per annum payable in advance and are due on January 1 of each year.
5. Company A may discontinue development and abandon the leasehold at the end of ten years, upon which any unpaid balance of the purchase price of the lease will become due and the property, with all its development and equipment, reverts to Company B.

During 1938 Company A drilled continuously and expended $630,000 for drilling, construction of field lines, and other work in the field, and produced 648,000 barrels of oil, which were all sold or delivered within the year. Company A realized an average of $1 per barrel on the sales of crude oil and all costs of producing and handling amounted to 40 cents per barrel on its own share of the oil produced, before depletion and land rentals.

It was agreed by the geologists of both companies that on January 1, 1938, the oil undergound capable of being produced from the wells existing on December 31, 1938, aggregated 2,400,000 gross barrels and that it will require ten years to produce it.

They also estimated that on January 1, 1938, the total oil reserves in the property amounted to 8,000,000 gross barrels and that, with an expenditure of $1,600,000 for additional wells and facilities, this oil can be produced during the life of the lease. The latter sum includes the estimated cost of keeping one string of drilling tools in continuous operation.

Company A, having in the meantime acquired other properties which produce crude oil of higher quality at lower cost, sought to revise the agreement. Company B offered to reduce, commencing January 1, 1939, the penalty for failure to continue drilling operations to $10,000 per annum, to operate the property using the existing wells and facilities, or any additional wells and facilities, to keep them in good operating condition, and to deliver to Company A its share of the crude oil for 35 cents per barrel. In other respects the terms of the contract were to remain the same.

Company A will charge depletion on the basis of actual exhaustion of the estimated oil reserves, without regard to the discovery value—and percentage depletion clauses in the federal income-tax law.

(a) What entries should be made by Company A on January 1, 1938?

(b) What is the gross profit or loss of Company A on the crude oil produced and sold in 1938?

(c) Which of the following alternatives will be the most advantageous to Company A, assuming that operating costs and sales prices remain the same, and that the wells and equipment have no salvage value:

1. Not to accept Company B's offer and to continue production and development.
2. Not to accept Company B's offer and to continue production, but to discontinue development.
3. Not to accept Company B's offer and to discontinue production as well as development.
4. To accept Company B's offer and to continue development.
5. To accept Company B's offer and to discontinue development.

No. 4 (40 points):

On January 2, 1938, Brown and Black jointly bought from Smith certain real estate on which two buildings had been erected. One of the buildings occupied two-thirds and the other the remaining one-third of the property.

The purchase price was $150,000 for the entire property, the seller (Smith) agreeing to pay off a $120,000 four-per-cent mortgage and other encumbrances attaching to the property. These encumbrances consisted of unpaid taxes for 1935, 1936, and 1937, that had become liens on the property on December 31 of each year. They were by mutual agreement accepted as being respectively $6,400, $5,700, and $5,700. Smith also agreed to bear the expenses incident to title search and guaranty.

Brown advanced $1,000 to bind the contract, and agreed to close the deal on February 15, 1938. He also agreed that the other expenses incident to the purchase and closing should be paid by Brown and Black.

On the same day, January 2, 1938, the two-thirds of the property was sold to Jones for $109,000 cash. Jones was to receive the net income from the property from that date on and to receive a clear title on February 15, 1938.

The above mortgage of $120,000 was held by the X Insurance Company. Interest had been paid to September 1, 1936, and since January 1, 1937, the mortgagee had operated the property.

To finance the above deals, insure proper payment of encumbrances, and make final cash settlements, Brown and Black designated the Y Trust Company as their depository and agent in the foregoing purchases and sales.

The Y Trust Company agreed to receive in escrow the $109,000 paid by Jones and to take a $42,000 four-per-cent mortgage on the remaining third of the property on February 15, 1938. From the $151,000 thus available the trust company was to pay off the $120,000 mortgage and settle with the X Insurance Company on the latter date. The trust company was also to pay or make provision for the encumbrances, attend to the transfer of title, and make final settlement with the other parties to the aforementioned sale and purchase transactions.

On February 15, 1938, the trust company had complied with all the foregoing terms and rendered the following accounting to Brown and Black:

Receipts	
From Jones—for the two-thirds of the property sold Jan. 2, 1938	$109,000
From Y Trust Company—for mortgage on the remaining third	42,000
	$151,000

Disbursements	
Revenue stamps	$ 150
Traveling expenses	128
Telephone and telegrams	52
Title search	1,364
Title guaranty policy	400
90% of 1935 and 1936 taxes	10,890
Held in escrow for balance of taxes	6,910
Jones	2,940
Smith	23,840
X Insurance Company—per account rendered	101,786
Brown and Black	2,540
	$151,000

The account rendered by the X Insurance Company was submitted with the above settlement, viz:

Amount of mortgage			$120,000
Interest from Sept. 1, 1936 to Dec. 31, 1937			6,400
Interest from Jan. 1, 1938 to Feb. 15, 1938			600
			$127,000
Less—Balance of operating income			
	1937	1938	
Rental income to Feb. 28, 1938	$32,400	$5,400	
Deduct—Operating expenses			
Heat, light and power	$ 2,400	$ 400	
Maintenance and repairs	4,300	250	
Salaries and wages	3,600	124	
Management fee—4%	1,296	216	
	$11,596	$ 990	
	$20,804	$4,410	25,214
Balance payable			$101,786

The transactions in the remainder of the year 1938 were as follows:

All rents, amounting to $9,000 were collected.
All operating expenses were paid to the amount of $2,700.
Semi-annual interest was paid on the mortgage when due.
The 1937 taxes were paid in the amount of $6,000.
The 1935 and 1936 taxes were settled at a reduction of 9 per cent.
Alterations costing $2,500 were made for a new tenant who took a five-year lease, beginning July 1st, at the rate of $125 per month.
The new tenant deposited $1,000 to secure the lease, applicable as rent for the last eight months of the term.
Black drew $100 per month management salary from February 15, 1938.
On December 31, 1938, the remaining third of the property was sold for $52,000 cash, Brown and Black assuming all encumbrances, including the 1938 taxes, which had accrued at the 1937 rate, and depositing their amount with the Y Trust Co.

From the foregoing data prepare the following accounts of Brown and Black:

1. A statement of profit and loss showing separately the profit or loss on the sale and on the operation of the property.
2. A statement of receipts and disbursements, also showing the final distribution of cash to the two partners.

Submit any necessary work sheets.