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American Institute of Accountants Examinations, November 16-17, 1939

American Institute of Accountants. Board of Examiners

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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 16 and 17, 1939.]

EXAMINATION IN AUDITING

November 16, 1939, 9 a.m. to 12:30 p.m.

[The candidate must answer all questions.]

No. 1 (5 points):

Under what heading and at what value should goods shipped to a customer, sight or time draft with bill of lading attached, be shown on the balance-sheet, where some of the drafts that should ordinarily have been paid or accepted have not yet been reported by the bank as settled?

No. 2 (5 points):

While examining the books and records of a corporation as at December 31, 1938, the following resolution is found in the directors' minutes of December, 1938:

"RESOLVED, That the officers of the company are directed as of January 1, 1939, to adjust the property values to a basis reflecting current values as estimated by the directors by writing off 10 per cent of such property values with a reduction in the reserves for depreciation in the same ratio, the net difference to be charged to earned surplus."

It is not the intention of the company to make such adjustment until 1939 but the president's letter to shareholders accompanying the December 31, 1938, balance-sheet will contain a reference to the write-off.

- (a) How should the foregoing be dealt with in the audited accounts submitted for the 1938 report to the shareholders?
- (b) How would you deal with the matter in 1939 and (c) thereafter? In each case state your reasons.

No. 3 (5 points):

Company B received from Company A a substantial order for merchandise and upon shipment Company B rendered a bill to Company A for the goods purchased. Through the misplacement of the decimal point the amount of the bill was exactly one tenth of what it should have been. Company A en-

tered and settled the bill at the smaller amount and, at the time the usual audit was being made, had not heard from Company B. The auditor discovered the error, although he was not expected to check the purchase invoices for clerical accuracy. Company A had to admit the error but did not permit its correction, placing the responsibility upon Company B.

The auditor was some time later engaged by Company B for a balance-sheet examination which likewise did not include a check of detail. Remembering the incident and anxious to see whether Company A had acknowledged the additional indebtedness and paid up, he found that the bill had also gone through Company B's books at the lower amount, that the error had not been discovered, that Company A's check had been received and credited in full settlement of the bill and that nothing had been heard from Company A.

State what the auditor should do in each examination. Give reasons.

No. 4 (5 points):

In connection with the usual verification of bank balances, state:

- (a) Whether the examination of canceled checks and their comparison with entries in the disbursement journal constitute an adequate audit of the disbursements.
- (b) What purpose is served by such an examination and comparison?
- (c) What further examination is necessary to make the audit adequate?

No. 5 (10 points):

A large U. S. concern owns foreign companies or branches that own and operate plants and sell their product in their respective countries. Their balance-sheets include among other accounts the following:

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1. Cash in restricted currencies.
2. Accounts receivable.
3. Inventories.
4. Capital assets.
5. Current liabilities.
6. Intercompany account payable.

The accounts of the foreign companies or branches were all converted at the official rates of exchange at the close of the fiscal year, and the exchange differences in consolidation carried forward as a debit under deferred charges. In auditing the accounts (a) what rates of exchange would you use in making the conversions of the above balances and (b) how would you recommend handling the exchange differences?

No. 6 (10 points):

When basic raw materials are processed by a series of operations, how should the cost of manufacture be allocated to the various products and by-products—

- (a) Where one principal commodity is produced in several classes and grades, leaving by-products that are sold without further processing?
- (b) Where two principal commodities are produced in diverse classes and grades after the raw material has passed through several intermediate processes, and in the successive stages of manufacture various by-products are recovered that are sold without further processing?

No. 7 (10 points):

In an engagement to examine the 1938 books and accounts of a corporation the following trial balance is submitted:

Assets	
Cash.....	\$ 250,000
Accounts receivable.....	800,000
Inventory of merchandise.....	750,000
Deferred charges.....	25,000
	<u>\$1,825,000</u>
Liabilities	
Notes payable.....	\$ 100,000
Accounts payable and accruals.....	500,000
Capital stock—\$100 par.....	1,100,000
Earned surplus.....	125,000
	<u>\$1,825,000</u>

The cash book shows a payment of \$200,000 made on January 2, 1939, to the president

which was described on the cash book as a "loan." It was found that \$200,000 was loaned him on October 3, 1938, and paid off on December 28, 1938, with interest. The president is a man of considerable means.

- (a) What position should you take in preparing the accounts of December 31, 1938, assuming that all other items on the trial balance were satisfactorily verified?
- (b) Give the balance-sheet you would be willing to certify.

No. 8 (10 points):

During the examination of the accounts of a real-estate company owning a large office building it is found that the receivables include a rather large amount of overdue rents.

The bookkeeper also acts as cashier and the manager of the building checks the collection of rents by comparing monthly lists of rents receivable furnished by the bookkeeper.

The rent rolls are kept by a clerk under the supervision of the bookkeeper; the former prepares the monthly rent bills and submits them to the bookkeeper who mails them to the tenants.

What procedure should be followed in a thorough test of the rental income?

No. 9 (10 points):

An examination of the balance-sheet of an industrial concern is made for credit purposes and the following conditions are discovered:

1. Cash includes a substantial sum specifically set aside for immediate reconstruction of plant and renewal of machinery.
2. Trade accounts receivable include a large amount of customers' notes of which a considerable number had been renewed several times and may have to be renewed continually for some time in the future. The interest is settled on each maturity date and the makers are in good credit standing.
3. Inventory includes retired machinery, some at regularly depreciated book value, other at scrap or sales value.
4. Surplus includes a sinking fund reserve, set up out of profits in accordance with the trust deed.

How should the foregoing items be shown on the balance-sheet? Give reasons.

No. 10 (10 points):

What is the customary procedure that should be followed by a large concern having

numerous branches, dealing with each other and with the head office, so as to insure prompt agreement of interoffice balances at the close of each accounting period?

No. 11 (20 points):

A large oil company has uniform sales contracts with all its distributors covering the allowance of special discounts on their purchases of lubricating oil.

At the end of each contract year each distributor receives a special discount of 1%, 2%, or 3% on his total purchases over and above a minimum amount that is the same for all. The rate is in each case determined by the bracket in which the total volume of purchases in his contract year has fallen. Contracts are made on any day of the year.

The company makes monthly provision for the accruing liability at a percentage of the total monthly oil sales. This percentage, it is alleged, equals the average rate of special discount allowed in the company's preceding fiscal year on the sales in the contract years

ended in that year to all distributors including those who were not entitled to any discount under the terms of their contracts. The discounts actually allowed as each distributor's contract year expires are charged to the accrual.

No current record is kept of the discounts as they accrue from month to month to each individual distributor and from the time the policy was adopted the company never attempted to determine whether the accrual shown on the books adequately covered the existing liability.

(a) State the procedure that, in a first audit, should be followed to check or test the adequacy of the accrued liability

1. in case the number of distributors is relatively small,
2. in case their number is large.

(b) Briefly outline a practical method whereby the liability can be determined at the end of each month with substantial accuracy.

(c) State how the change from one method to the other should be brought about.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

November 16, 1939, 1:30 P.M. to 7:30 P.M.

[Solve all problems.]

No. 1 (10 points):

From the following comparative summary and additional information given, prepare a statement of application of funds:

**AMES MANUFACTURING COMPANY
COMPARATIVE SUMMARY OF BALANCE-SHEETS**

	<i>Assets</i>		
	December 31		Increase <i>Decrease</i> *
	1937	1938	
Current assets:			
Cash.....	\$ 85,000	\$ 35,000	\$ 50,000*
Receivables (net).....	106,000	103,000	3,000*
Inventories.....	158,000	146,000	12,000*
	<hr/>	<hr/>	<hr/>
	\$ 349,000	\$ 284,000	\$ 65,000*
	<hr/>	<hr/>	
Prepaid insurance, taxes, etc.....	\$ 8,000	\$ 7,000	\$ 1,000*
Bond discount and expenses in process of amortization	40,000	65,000	25,000
Sinking-fund deposit account.....	3,000	5,000	2,000

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Property, plant, and equipment.....	\$1,860,000	\$2,810,000	\$950,000
Less—Reserves for depreciation.....	852,000	879,000	27,000
	<u>\$1,008,000</u>	<u>\$1,931,000</u>	<u>\$923,000</u>
	<u>\$1,408,000</u>	<u>\$2,292,000</u>	<u>\$884,000</u>

Liabilities

Current liabilities:

Bank loans.....	\$	\$ 100,000	\$100,000
Current maturities of equipment obligations.....		25,000	25,000
Accounts payable.....	63,000	42,000	21,000*
Accrued expenses.....	105,000	82,000	23,000*
	<u>\$ 168,000</u>	<u>\$ 249,000</u>	<u>\$ 81,000</u>

Long-term debt:

5% first-mortgage, sinking-fund bonds due January 1, 1950.....	\$ 650,000	\$ 975,000	\$325,000
Deferred equipment obligations.....		150,000	150,000
	<u>\$ 650,000</u>	<u>\$1,125,000</u>	<u>\$475,000</u>

Capital stock and surplus:

Capital stock.....	\$ 250,000	\$ 350,000	\$100,000
Paid-in surplus.....	250,000	350,000	100,000
Earned surplus.....	90,000	218,000	128,000
	<u>\$ 590,000</u>	<u>\$ 918,000</u>	<u>\$328,000</u>
	<u>\$1,408,000</u>	<u>\$2,292,000</u>	<u>\$884,000</u>

Additional information given:

- (a) Property retirements recorded for the year aggregated \$100,000. The excess of such cost over \$10,000 salvage realized was charged to depreciation reserves.
- (b) Additional securities were sold during the year as follows:
2,000 shares of capital stock of \$50 par value, sold at \$100 per share
\$350,000 par value of first mortgage bonds sold at 90
\$175,000 deferred equipment notes at par
- (c) Bonds are subject to retirement through a sinking fund created by annual deposits of \$25,000 on March 15th. Bonds retired through the sinking fund in 1938 aggregating \$25,000 were bought in for \$22,000 plus accrued interest of \$1,000.
- (d) Provisions made by the company for the year 1938 for depreciation and for the amortization of bond discount and expenses were correctly computed.
- (e) The following analysis was made of earned surplus:

Balance at December 31, 1937.....	\$ 90,000
Net profit for the year after providing depreciation of \$92,000.....	175,000
Discount on bonds retired.....	3,000
	<u>\$268,000</u>

Deduct:

Dividends paid.....	\$25,000
Adjustment of depreciation reserves at December 31, 1937, to basis of treasury department report.....	25,000
	<u>\$218,000</u>

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No. 2 (25 points):

The Sulphur Company, organized January 1, 1934, was formed to mine, refine, and sell sulphur. To that end it secured a twenty-year lease on 500 acres of known sulphur deposits, referred to as section A, and 500 acres, referred to as section B, of potential but undiscovered sulphur deposits. It was estimated

after engineers' survey that there were 5,000,000 tons of sulphur under section A at the time of acquisition. Mine reports showed the number of tons taken out by years as follows: 1934, 250,000; 1935, 300,000; 1936, 500,000; 1937, 800,000; 1938, 1,000,000 of which 200,000 tons remained in stock-pile.

The following statement is prepared by the company's bookkeeper:

BALANCE-SHEET December 31, 1938

Cash.....	\$ 500,000	Current liabilities including interest and taxes accrued.....	\$ 150,000
Receivables.....	300,000	Bonds payable.....	300,000
Inventory of crude sulphur at cost of mining and extraction (Market value \$200,000).....	180,000	Capital stock.....	1,000,000
Leaseholds—at cost.....	600,000	Surplus.....	610,000
Section A—\$500,000		Profit and loss, 1938.....	230,000
Section B— 100,000			
Plant and equipment.....	460,000		
Development—Section A.....	200,000		
Prospecting—Section B.....	50,000		
	<u>\$2,290,000</u>		<u>\$2,290,000</u>

This statement is correct and all accounting requirements have been met, except that the company has never provided for amortization or depletion since, in the words of the company's president, "it had discovered from prospecting more new deposits than it had mined." Nor has provision been made for depreciation or obsolescence of plant and equipment acquired January 1, 1934, which are estimated to have a useful life greater than the twenty-year period of the leases and a scrap value of \$50,000.

The company had a survey made of section B by competent engineers. This survey indicated sulphur deposits of 3,200,000 tons on January 1, 1938, which were estimated to have a fair value underground of 11 cents per ton. It was decided to increase the book value of the leasehold, now carried at \$100,000, to that value. It was also decided that the company would charge the operations with depletion on the basis of the increased value, although this would not affect the depletion deductible for tax purposes.

Of the total 1938 production of 1,000,000 tons, 400,000 tons were mined from section B, all of which were sold in 1938. Prior to December 31, 1938, the bookkeeper had written down development costs by \$50,000, charging this amount to surplus.

From the foregoing data prepare:

- (a) Journal entries setting up the proper reserves and making necessary adjustments to other accounts.
- (b) Columnar work sheet showing the changes caused by the adjustments.
- (c) Final balance-sheet.

No. 3 (30 points):

Part one (18 points)

On January 1, 1938, the City of M had the following assets:

Cash in bank.....	\$ 15,000
Taxes receivable.....	50,000
Tax title liens.....	35,000
	<u>\$100,000</u>

It also had the following liabilities and reserves:

Creditors.....	\$ 4,000
School board.....	10,000
Tax revenue notes.....	6,000
Reserve for taxes and liens.....	70,000
Surplus revenue.....	10,000
	<u>\$100,000</u>

On January 31, 1938, the budget was adopted as follows:

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Resources:

Surplus revenue appropriated....	\$ 5,000
License fees and permits.....	15,000
Delinquent taxes and liens.....	40,000
Current year's taxes.....	30,000
	<u>\$ 90,000</u>

Appropriations:

Salaries.....	\$ 8,000
Office expenses.....	6,000
Garbage collection.....	7,000
Reserve for uncollectible tax-title liens.....	5,000
School board.....	50,000
Reserve for uncollectible 1938 taxes.....	14,000
	<u>\$ 90,000</u>

During 1938 the cash collections were:

Tax-title liens.....	\$ 3,000
License fees and permits.....	17,000
Delinquent taxes.....	38,000
1938 taxes.....	36,000
	<u>\$ 94,000</u>

And the following disbursements were made:

Salaries.....	\$ 19,000
Office expenses.....	7,000
Garbage collections.....	8,000
School board.....	30,000
1937 bills in full settlement of all claims.....	3,920
	<u>\$ 67,920</u>

Taxes assessed for 1938 amounted to \$66,200. Unpaid liabilities on December 31, 1938, aggregating \$1,200 had been incurred for office expenses. Taxes receivable for 1938 were cancelled to the amount of \$500.

Prepare the following statements:

- (Ia) Balance-sheet at December 31, 1938.
- (Ib) Reserve for taxes and liens.
- (Ic) Surplus revenue (unappropriated surplus).

Submit journal entries and work sheets.

Part two (12 points)

The city also built and operated its own water plant in 1938 for which it passed an ordinance appropriating the sum of \$150,000, the amount of the contract for the plant, and authorizing the issue of not over \$150,000

bonds. Of these bonds \$145,000 were sold for \$150,500 cash.

Water rents billed to consumers amounted to \$26,000 on which \$22,000 was collected.

The total cost of the plant was \$154,000, and the contractor was paid \$150,000, leaving \$4,000 owing him on December 31, 1938.

In 1938 the following disbursements were made:

Office salaries.....	\$ 2,000
Water meter reader's salary.....	2,000
Bonds redeemed at par.....	10,000
Interest on bonds.....	4,500

Prepare the following statements:

- (IIa) Balance-sheet for capital fund.
- (IIb) Balance-sheet for operating fund.

Submit journal entries and work sheets for both funds.

No. 4 (35 points):

The HKH Oxygen Company operates two producing units—an electrolytic unit and a liquefaction unit, each of which, when operating, produces at capacity.

1. Electrolytic unit

The electrolytic unit produces one volume of oxygen and two volumes of hydrogen simultaneously and this production ratio is maintained throughout, whenever the unit operates. The unit consists of a number of metal tanks, or "cells," containing electrodes carrying low-voltage, high-amperage electrical current.

Water is a compound of oxygen and hydrogen. The positive electrical terminal in each cell attracts oxygen, the negative terminal attracts hydrogen. They bubble off as gases and are collected commercially pure at the rate of 800 cubic feet of oxygen and 1600 cubic feet of hydrogen per hour. Distilled water is continuously added to the cells.

The operating record of the unit for the year was:

7,100 hours producing both gases
500 hours producing hydrogen only, all oxygen escaping because empty cylinders were not available
400 hours producing oxygen only, all hydrogen escaping for the same reason
760 hours idle, repair, etc.
<u>8,760 hours, being 365 days of 24 hours</u>

The entire cost of operating the electrolytic unit during the year was \$48,000 which includes depreciation. Since the above production ratio of 1 to 2 is constant, this cost is to be apportioned between the two gases on the basis of volume actually produced by the unit. The production cost value of the gases lost is to be treated as a deduction from the gross profit on sales.

2. Liquefaction unit

The liquefaction unit separates atmospheric air (containing 20% oxygen and 80% nitrogen) by mechanical means. Air is compressed and expanded and the temperature lowered to about 300° Fahrenheit below zero, which liquefies the air. The unit produces liquid air at a uniform rate.

Oxygen and nitrogen boil (leave the liquid air as gases) at different temperatures, and one or the other (but not both together) is collected commercially pure. The operating record of the unit during the year was:

Oxygen—7,200 hours at the rate of 1,000 cubic feet per hour
 Nitrogen—1,200 hours at the rate of 1,333½ cubic feet per hour

The operating cost of the liquefaction unit, including depreciation, aggregated \$30,240 for the year. Because of the uniform rate of

production this cost is to be apportioned between the two gases on the basis of the number of hours operating.

3. Compressing and filling

The gases are filled into steel cylinders, each of which is always used for the same gas. They are all of the same capacity (except the oxygen 110's) and they are filled at a uniform pressure by three very similar compressors, each compressing only one gas. However, the gases differ in compressibility and the cylinder contents are shown below.

The cost of compression was \$13,480.00 for the year including depreciation of the compressors and the cost is to be allocated to the gases produced on the basis of cubic feet compressed.

The cost of filling, that is, connecting and disconnecting cylinders at the charging line, amounted to \$5,643 and is the same for each cylinder, large or small. During the year 6,000 small oxygen cylinders were filled.

4. Cylinders

Each cylinder is always refilled with the same gas. They are always returned when empty and no charge is made for their use. The following data are given concerning the number of cylinders owned (all in service) and their depreciation:

	Contents Cu. ft.	Number owned	Depreciation	
			Rate	Amount
Hydrogen.....	190	5,120	\$2.09	\$10,700.80
Oxygen.....	220	10,260	2.09	21,443.40
Oxygen.....	110	1,508	1.32	1,990.56
Nitrogen.....	200	1,662	2.09	3,473.58

5. Other data

At the beginning of the year there were on hand 310 full nitrogen cylinders of which the contents of 62,000 cubic feet were carried forward at the previous year's cost of \$.424 per 100 cubic feet or \$262.88. All other cylinders were on hand empty.

At the end of the year 200 full small oxygen cylinders were on hand; their contents, 22,000 cubic feet, are carried forward at the average year's cost. All other cylinders were on hand empty.

All gases are valued for inventory purposes at average cost before charging depreciation of cylinders.

The average sales prices of the gases were as follows:

Hydrogen (in large cylinders) \$.80 per 100 cubic feet.
 Oxygen (in large cylinders) \$1.00 per 100 cubic feet.
 Oxygen (in small cylinders) \$1.20 per 100 cubic feet.
 Nitrogen (in large cylinders) \$1.20 per 100 cubic feet.

The total of all selling, general and executive expenses, interest and taxes was \$76,375.

6. Required

From the foregoing information prepare the following statements:

- (a) Cost of production and sales
- (b) Profit and loss

Also show the calculations of operating data and the apportionment of costs.

EXAMINATION IN COMMERCIAL LAW

November 17, 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):

State several conditions or circumstances in which a duly appointed agent may become personally liable to third persons with whom he deals.

No. 2 (10 points):

A depositor in a bank learned that the bank had dishonored several small checks drawn by him on the ground of "insufficient funds," although the depositor's balance had been sufficient to cover them. Upon investigation, he found that the bank had charged his account with \$80 paid by it on another check drawn by him which stated the amount in figures as \$80, but in writing as "Eight and no/100 Dollars," and which he had regarded and intended as a check for \$8. The insufficiency of funds according to the bank's accounts had resulted from this transaction. What principles of law are involved in determining whether the depositor has any legally enforceable claim against the bank for damages?

No. 3 (10 points):

- (a) Define a dividend by a corporation.
- (b) In what media other than cash may such a dividend be payable?
- (c) State each step with respect to dividends ordinarily taken by a corporation with several hundred stockholders and men-

tion the rules or principles of law, if any, applicable to each step.

No. 4 (10 points):

X and Y were partners under a valid partnership agreement which recited the capital contribution of each and provided for the equal division of all profits but made no mention of losses or of the details of settlement upon dissolution. They decided to dissolve and they signed a valid dissolution agreement which provided that the firm's accounts receivable, after collection, were to be divided one-third to X and two-thirds to Y until such distribution had reimbursed each partner in full for the balance of his capital contribution; thereafter, any further collections were to be divided equally. This agreement made no mention of losses. It was soon discovered that collectible accounts would be insufficient by \$12,000 to reimburse both partners for their combined capital balances. X claims that only one-third of this loss should be charged to him. Is this claim by X legally valid?

No. 5 (10 points):

- (a) State the various conditions or circumstances which would make a contract fraudulent.
- (b) What remedies has the innocent party to a contract which has been procured or induced by fraud?

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 corporation duly executed and issued a legally binding negotiable promissory note, on which the president of the corporation was an accommodation indorser. Prior to maturity of the note, the president initiated and conducted bankruptcy proceedings for the

corporation with the result that when the note matured the corporation was without funds, its business suspended, its place of business closed, and its property in the hands of a receiver. Upon due presentation of this note, the corporation failed to pay it but no notice of dishonor was given to said indorser who still was president. Can the president be

held liable on his indorsement? What rule or principle of law is involved?

No. 7 (10 points):

Where one person properly has legal title to all of the capital stock of a duly organized corporation, in what circumstances will courts disregard the separate entity of the corporation and hold the sole stockholder personally liable for obligations incurred in the name of the corporation?

No. 8 (10 points):

X and Y were having a genuine controversy as to the amount of indebtedness due by X to Y when X mailed to Y X's check for an amount less than that claimed by Y. On the face of this check X had written "This check is in full settlement of my indebtedness to Y," and with the check X enclosed a letter written by him to Y in which he stated that the enclosed check was in full settlement. Y did not acknowledge receipt, or otherwise communicate with X, or do anything whatever with this check except to retain it in his office for two months.

- (a) Can X successfully claim that his indebtedness had been settled in full?

What is the legal name of the agreement, or method, of settlement attempted by X?

No. 9 (10 points):

- (a) What is the name of the principle of law by which a state, or a subdivision of a state, is permitted to institute proceedings to obtain privately owned real property for a public purpose?
- (b) Where such real property includes a building in which a tenant of the owner had installed and used factory machin-

ery, in what circumstances must the damages awarded in the condemnation proceeding include the value of such machinery?

No. 10 (10 points):

If a mortgagor and a mortgagee of real property validly agree to a reduction of the interest rate but fail to notify a guarantor of the mortgage, who does not learn of this reduction until the maturity of the debt, is the guarantor thereby released from his guaranty of the principal of the mortgage?

No. 11 (10 points):

A solicitor was hired by a corporation to develop its business by procuring new customers, his compensation to consist of commissions. The contract specified that the employment could be terminated by either party on one week's notice and that in the event of termination by either party the solicitor was not to solicit for himself or for any other business organization within the county or within any adjoining county during a period of ten years thereafter.

- (a) Is the ten-year provision legally valid?
- (b) Would a similar provision be valid if the promise not to solicit was made by the owner of a business as part of a contract whereby the owner sold his entire business (including goodwill) to another person?

No. 12 (10 points):

Define briefly:

- (a) Slander.
- (b) Libel, as distinguished from slander.
- (c) Equity, as distinguished from common law.
- (d) Bailment.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

November 17, 1939, 1:30 P.M. to 7:30 P.M.

[Solve all problems.]

No. 1 (10 points):

A, B, and C have been partners throughout the year 1938. Their average balances for the year and their balances at the end of the year, before closing the nominal accounts, are as follows:

	Average balances	Balances Dec. 31, 1938
A.....	Cr. \$90,000	Cr. \$60,000
B.....	Cr. 3,000	Dr. 1,000
C.....	Cr. 7,000	Cr. 10,000

The profit for 1938 is \$75,000 before charging

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partners' drawing allowances and before interest on average balances at the agreed rate of 4% per annum. A is entitled to a drawing account credit of \$10,000, B of \$7,000, and C of \$5,000 per annum. The balance of profit is to be distributed at the rate of 60% to A, 30% to B, and 10% to C.

It is intended to distribute amounts of cash to the partners so that, after credits and distributions as indicated in the preceding paragraph, the balances in the partners' accounts will be proportionate to their profit-sharing ratios. None of the partners is to pay in any money, but it is desired to distribute the lowest possible amount of cash.

Prepare a statement of the partners' accounts, showing balances at the end of 1938 before closing, the allocations of the net profit for 1938, the cash distributed, and the closing balances.

No. 2 (25 points):

On January 1, 1938, the Acme Carburetor Company acquired control of the Airex

Manufacturing Company by purchasing 1,000 shares of preferred stock (the entire issue) and 8,000 shares of common stock (80% of the outstanding shares). The sole product of the Airex Company is an air cleaner which is used in the assembly of the carburetors manufactured by the Acme Company.

The machinery and equipment of the Airex Company was appraised as of January 1, 1938, at a net sound value of \$300,000 representing reproductive value of \$500,000 less accrued depreciation of \$200,000. The books of the Airex Company were not adjusted to this appraisal, although the directors of that company had authorized the adjustment.

The purchase price of the above preferred and common shares was \$400,000 and was based on the appraised value of the equity in fixed assets acquired and the book value of other net assets.

The following statement of trial balances of December 31, 1938, was presented:

	Acme Carburetor Company	Airex Manufacturing Company	Combined trial balance
Assets			
Cash	\$ 75,000	\$ 50,000	\$ 125,000
Accounts receivable	150,000	100,000	250,000
Accounts receivable—Intercompany		25,000	25,000
Inventory	270,000	145,000	415,000
Fixed assets			
Land	150,000		150,000
Buildings	350,000		350,000
Machinery and equipment	700,000	700,000	1,400,000
	1,200,000	700,000	1,900,000
Less—Reserve for depreciation	366,500	256,000	622,500
	833,500	444,000	1,277,500
Investment in Airex Co. stock	400,000		400,000
Deferred charges	10,000	5,000	15,000
	<u>\$1,738,500</u>	<u>\$769,000</u>	<u>\$2,507,500</u>
Liabilities and capital			
Accounts payable	\$ 75,000	\$ 31,000	\$ 106,000
Accounts payable—Intercompany	25,000		25,000
Common stock	750,000	10,000	760,000
Preferred stock		100,000	100,000
Earned surplus	700,000	559,000	1,259,000

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Profit and loss			
Sales.....	\$1,500,000	\$850,000	\$2,350,000
Other income.....	10,000		10,000
	<u>1,510,000</u>	<u>850,000</u>	<u>2,360,000</u>
Materials used.....	800,000	400,000	1,200,000
Factory labor.....	200,000	125,000	325,000
Manufacturing expenses.....	221,500	206,000	427,500
Selling and general expenses.....	100,000	50,000	150,000
	<u>1,321,500</u>	<u>781,000</u>	<u>2,102,500</u>
	<u>188,500</u>	<u>69,000</u>	<u>257,500</u>
	<u>\$1,738,500</u>	<u>\$769,000</u>	<u>\$2,507,500</u>

Depreciation had been provided by both companies at the rate of 3% on buildings and 8% on machinery and equipment.

The Acme Company's purchases from the Airex Company amounted to \$350,000 in 1938 and at the end of the year \$80,000 of these purchases were included in the Acme Company's inventory.

The common stock of both companies is of no par value. The Acme Company has 7,500 shares outstanding and the Airex Company 10,000 shares. No dividends were paid in 1938 by either company on its common stock.

The preferred stock of the Airex Company is 6% cumulative. Dividends have been regularly paid on June 30th and December 31st of each year and were charged to surplus.

Federal income and profits taxes need not be considered.

From the foregoing prepare a columnar work sheet showing the consolidated balance-sheet as well as the consolidated profit-and-loss account. Do not show eliminations and adjustments together, but use separate columns for each.

No. 3 (30 points):

On the petition of principal creditors, receivers in bankruptcy were appointed for the Skihigh Liquor Company on September 30, 1939. Appraisers appointed by the court took a physical inventory on the morning of October 1, 1939, finding the following merchandise on the premises:

	Cases of 12 bottles
Spirits:	
Old Mahogany rye.....	40
Filibuster Special bourbon.....	10
Old Bluebottle.....	5
Wines:	
Sparkling muscatel.....	20
Beers:	
The Brewers Own.....	60

Accountants appointed by the receivers on October 1, 1939, found that the books had not been posted since September 15, 1939, when accounts had been prepared for the purpose of obtaining a bank loan. The trial balance of that date was as follows:

	Dr.	Cr.
Cash in bank.....	\$ 500.00	
Petty cash.....	100.00	
Accounts receivable.....	7,609.66	
Accounts receivable—assigned.....	12,000.50	
Note receivable.....	190.00	
Note receivable—officer.....	300.00	
Advances to salesmen.....	6,000.00	
Inventories:		
Spirits.....	3,180.00	
Wines.....	360.00	
Beers.....	375.00	
Inventories—assigned.....	10,006.54	
Insurance, taxes and rent prepaid to Sept. 30, 1939.....	1,866.66	

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Life insurance policy.....	\$ 4,000.00	
Notes payable—president.....		\$ 2,000.00
Accounts payable.....		55,100.90
Accrued sales taxes.....		900.12
Capital stock.....		10,000.00
Deficit.....	21,512.66	
	<u>\$68,001.02</u>	<u>\$68,001.02</u>

On the basis of these accounts a loan of \$5,000 was obtained from the bank on the agreement that accounts receivable collections (after September 15th) be deposited in a special account at the bank, amounts to be

withdrawn therefrom only as approved by the bank.

Cash transactions from September 15 to 30, 1939, were as follows:

Collections:

Accounts receivable deposited in special bank a/c.....	\$ 2,005.00
Accounts receivable—assigned—deposited in special bank a/c.....	12,000.50
Note receivable.....	190.00
Advances to salesmen.....	500.00
Proceeds of bank loan of \$5,000.....	4,900.00
Total.....	<u>\$19,595.50</u>

Disbursements:

President's note payable.....	\$ 2,000.00
Accounts payable.....	5,000.00
Liquor license for year to September 30, 1940.....	1,000.00
Advances to salesmen.....	1,000.00
Petty expenses (paid from petty cash).....	100.00
Total.....	<u>\$ 9,100.00</u>

An amount of \$7,000 had been transferred from the special account to the regular drawing account as approved by the bank.

There were no purchases during the period

from September 15 to September 30, 1939. Verified sales during the period, all on credit, were as follows:

	Cases	Per case (net)	Total
Spirits:			
Old Mahogany rye.....	10	\$30	\$300
Filibuster Special bourbon.....	5	20	100
Old Bluebottle.....	5	12	60
Wines:			
Sparkling muscatel.....	10	15	150
Beers:			
The Brewers Own.....	40	2	80
			<u>\$690</u>

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The perpetual stock records showed the following goods on hand at the close of business September 15th:

	Cases of 12 bottles	Cost per case
Spirits:		
Old Mahogany rye.....	100	\$24.00
Filibuster Special bourbon.....	40	18.00
Old Bluebottle.....	10	6.00
Wines:		
Sparkling muscatel.....	30	12.00
Beers:		
The Brewers Own.....	250	1.50

Among the accounts payable of September 15, 1939, is a debt of \$21,007.04 to a distillery, representing two successive shipments of \$11,000.50 and \$10,006.54. The first shipment had been sold for \$12,000.50 and the customer's account pledged to the distillery as security. The second shipment had been stored in bonded warehouse, but the title to the goods was passed back to the distillery on September 28, 1939.

The life-insurance policy (surrender value at September 15, 1939, \$2,500) was on the life of the president of the company, but it had been assigned to his wife some years ago.

The receivers expect that the bank will attempt to attach all balances at September 30, 1939, and that also other creditors will assert their claims are preferential.

The attorneys appointed by the receivers request that you prepare at once a balance-sheet of September 15, 1939, on a going concern basis and a tentative balance-sheet of September 30, 1939, for purposes of a discussion on October 2, 1939. A report or memorandum containing full notes should accompany the balance-sheets so that the attorneys may be informed as to the facts so far determined.

No. 4 (35 points):

A manufacturer wishes to enter the hosiery knitting business but lacks sufficient capital. Hoping to obtain the necessary additional funds from temporary bank loans by indicating substantial potential profits, he has requested that the following projected statements or budgets be prepared by quarters, starting with the third quarter in 1940 and ending with the quarter in which it is estimated that all bank borrowings have been liquidated:

- (a) Statements of cash receipts and disbursements.
- (b) Balance-sheets.
- (c) Statements of profit and loss.

Prepare these statements and indicate what responsibility the public accountant should assume.

The statements are to be based upon estimates and assumptions furnished by the manufacturer as listed below.

1. It is proposed that the corporation will begin business on July 1, 1940, with a cash capital of \$100,000, all paid in.

2. Knitting machinery consisting of eight units costing \$170,000 will be ordered at once; delivery will require one month; and payment will be made as follows:

10% in cash with order

10% in cash on delivery

80% by notes dated August 1, 1940, maturing quarterly in equal amounts over two years, the first note falling due at the end of the 1st quarter of 1941. Interest at 6% will be paid quarterly on unpaid notes.

3. Auxiliary machinery will cost \$8,000; factory furniture, fixtures, etc., will cost \$2,000; both items will be purchased at once for cash.

4. Borrowings in units of \$25,000 each, 6% interest (payable at the end of each quarter), will be made as required at the beginning of quarters; repayments of not less than \$25,000 each will be made when possible at the end of quarters. Cash balances must be budgeted never to be less than \$20,000.

5. Quarterly production of hosiery will be as follows:

4th quarter of 1940.....	4,000 dozen
1st quarter of 1941.....	6,000 "
Quarterly thereafter.....	24,000 "

6. Costs of production will be as follows:

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Direct costs per dozen pairs of hosiery produced

Thrown silk (purchased on terms of 90 days net).....	\$ 3
Direct labor, dyeing, etc.....	2
Factory overhead, by quarters:	
Starting at once.....	2,000
4th quarter of 1940.....	4,000
1st quarter of 1941.....	9,000
Quarterly thereafter.....	15,000

Depreciation of fixed assets at a composite rate of 8% per annum will be provided starting with the 4th quarter of 1940.

7. Selling expenses will be \$20,000 each quarter, starting at once.

8. General and administrative expenses by quarters will be as follows:

Starting at once.....	\$3,000
4th quarter of 1940.....	5,000
Quarterly thereafter.....	6,000

9. Hosiery manufactured will be sold at the following prices:

80% firsts at.....	\$12.00 per dozen
20% seconds at.....	2.00 " "

With every four dozen firsts, one dozen seconds will be sold.

10. Customers' terms will be thirty days net. It will be assumed that payments will be received when due, that there will be no bad debts, and that each month's sales will equal one third of the quarter's sales.

11. Inventories of thrown silk will be one half of the consumption in the succeeding quarter.

12. Inventories of finished hosiery (it will be assumed that hosiery in process will be finished at the ends of quarters) will be as follows:

End of 4th quarter of 1940...	1,000 dozen
End of 1st quarter of 1941...	1,000 "
End of each quarter thereafter	4,000 "

13. Inventory valuation of finished hosiery will be based upon cost at maximum production.

14. Provision for federal income taxes will be made only at the close of the calendar years, and will not be considered in the preparation of the projected statements.