Part I – Financial Statement Errors (15 points)

In each of the following questions, I have described transactions that were either "missed" or were recorded wrong. Fiscal year end (i.e., end of the annual reporting period) is December 31. For each question, show by what amount the financial statements are misstated without the effect of any corrections that should be made.Ignore taxes.Indicate the amounts involved and the effects on each of the financial statement component listed, using the following notation:overstated (O), understated (U) or no effect (NE).Provide an explanation for your solution.

If there is no effect in a given component, write "NE" in the respective space (i.e., do not leave it blank or else you will lose points).Questions are independent of one another (i.e., the transaction or event in the first question does not affect the second question and so on).

*Example:*A firm neglected to record a payment to a supplier of $10,000.

Current Assets	**(O) 10,000**	Long-term assets	NE
Current Liabilities	**(O) 10,000**	Long-term liabilities	NE
Capital Stock	NE	Retained Earnings	NE

***Explanation:*Current Assets are overstatedbecause a $10,000 cash payment is not recorded (overstating the cash account, thereby overstating the current assets). Because the payment to the supplier is not recorded, the corresponding liability is not reduced by $10,000, thereby overstating accounts payable (a component of current liabilities).**

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1.In the middle of the fiscal year, on July 1st, The Bite purchased a new coffee machine for $10,000 in cash.The coffee machine has a 5-year useful life and a salvage value of $500.The accountant forgot to record ANY entries related to the purchase and depreciation of the coffee machine during the year.

Current Assets	**(O) 10,000**	Long-term assets	**(U) 9,050**
Current Liabilities	NE	Long-term liabilities	(U)
Capital Stock	NE	Retained Earnings	**(O) 950**

Explanation:

Current Assets are overstated because a $ 10,000 cash payment was not recorded (overstating the cash account, thereby overstating the current assets), Long term assets are understated as coffee machine purchased was not recorded and nor the depreciation charged on it for half year, so the long term asset got understated by $ 9,050 and as depreciation expenses was not recorded the Retained Earnings got overstated by $ 950.

2. Microhard Inc. manufactures and sells a bundled product of software and technical support for one year to its clients. Microhard typically receives payment from its customers upfront for this product.In the last month of the 2011 fiscal year, Microhard received $750,000 in cash from its customers for payment in full. Microhard delivered the software to its client at the time of the cash collection but it will start providing the technical support in the first month of 2012. Microhard's management is struggling to report earnings that will meet analysts' forecasts, and they recognized $750,000 cash collection as revenue for 2011.Assume that 1/3 of the cash collection was for technical support.

Current Assets	NE	Long-term assets	NE
Current Liabilities	**(U) $ 2,50,000**	Long-term liabilities	NE
Capital Stock	NE	Retained Earnings	**(O) $ 2,50,000**

Explanation:

Current liabilities are understated by $ 2,50,000 because out of $ 7,50,000, 1/3 ($2,50,000) was for technical support. As support was not provided in fiscal year 2011 so it will be considered as an advance from customer creating current liabilities. As the technical support was not provided in the previous year hence the revenue would be recognized in the year in which the services are provided. As service was provided in year 2012 so revenue should be recognized in fiscal year 2012 and not in year 2011.

3.Rolls-Royce Holdings plc derives its revenues from long-term contracts in its marine business and uses the percentage-of-completion method to recognize its revenues.The UK Government recently awarded Rolls-Royce a contract to develop a new propulsion system for submarines.Assume that the total value of this contract is £3 billion and is expected to take three years, and cost £500 million in each year.The actual costs in the first year were as expected.After the first year of the contract, suppose that Rolls-Royce recognized £2 billion of revenues.

Revenues	NE
Expenses	NE
Retained Earnings	NE

Explanation:

In Percentage completion method revenue is recognized as per the percentage of completion of project. Percentage completion= Period Revenue/ Total Project Revenue

Percentage completed=2/3*100= 66.67%, so revenue recognized = 66.67% of GBP 3 billion= GBP 2 Billion.
Expenses are recognized as per actual. So revenue, expenses and retained earnings have been recorded correctly.

Part II: Long-lived Assets—London Business School(25 points)

Please answer the following questions using the excerpts below from London Business School's financial statements pertaining to fiscal year ended 31 July 2011.For simplicity, the questions refer to this fiscal year as 2011.

1. What is the net book value of tangible assets (as reported at the end of 2011)?

   GBP 76,028,000

2. What is the balance of accumulated depreciation at the end of 2011?

   6350/76067*76028=GBP 63,46,744.43

3. What was the depreciation expense London Business School reported for 2011?For which kind of tangible asset does it incur the largest depreciation expense as a proportion of the total depreciation expense?

   4036/76067*76028= GBP 4033930.71.
   For long lease hold building depreciation charged is highest.

4. Which tangible asset category does London Business School depreciate the slowest (i.e. assumes the longest useful life)?

   Land and Building

5. Assuming no salvage value for computer equipment, what is the length of useful life London Business School uses for this kind of tangible equipment?

   3 Years

6. List three reasons that contributed to the change from the end of 2010 to the end of 2011 in the net book value of the tangible assets?

   The three reasons are:
   1. Charge of depreciation.
   2. Revaluation of assets.
   3. Capitalization of heritage assets and addition of assets.

7. Did London Business School revalue any tangible assets in 2011?

   Yes

8. What is the net book value (in thousand GBP) of the freehold and long leasehold (land and buildings) as reported at the end of 2011?

   19850+47000+1500=GBP 68,350,000

9. How much accumulated depreciation did London Business School report at the end of 2011 for the tangible assets that were revalued?

   GBP 0.00

10. What amount of costs did London Business School capitalize in 2011 that pertained to the assets in course of construction? List four potential cost items that could be included in this amount.

    GBP 4,449,000.
    We can capitalize any cost that is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended. List of four potential cost of items could be included in this amount are:
    a. Cost of site preparation
    b. Initial delivery and handling cost
    c. Installation and assembly cost
    d. Cost of employee benefit arising directly from the construction.

11. What is the effect of £7,545 decrease in the gross book value of tangible asset category, “Facility improvements” on the overall gross book value tangible assets London Business School reported at the end of 2011?Why?

    No effect on overall gross book value of tangible asset as the transfer is made within the group. With decrease in book value of "facility improvements" there is corresponding increase in the value of land and building.

12. How much pre-tax gain or loss would London Business School need to report in 2012, had it sold all of its freehold land and buildings on August 1, 2011 (first day of the new fiscal year) for £20 million?

Pre tax gain on free hold land and building= GBP(2,00,00000-1,98,50,000)
= GBP 15,00,000

Consolidated income and expenditure account

for the year ended 31 July 2011

	Notes	2011 £'000	2010 £'000
INCOME			
Academic fees	1	83,679	74,327
Funding Council grants	2	6,757	8,077
Research grants and contracts		1,475	2,071
Other income	3	6,825	6,027
Endowment and investment income	4	836	797
Total income		99,572	91,299
EXPENDITURE			
Staff costs	6	48,864	46,914
Other operating expenses	7	45,714	41,048
Depreciation	10	4,036	4,051
Loss on revaluation of properties		1,560	–
Total expenditure		100,174	92,013
Deficit after depreciation of tangible fixed assets and before tax		(602)	(714)
Taxation	8	–	–
Deficit after depreciation of tangible fixed assets and tax	9	(602)	(714)
Share of operating surplus of associate company	11	116	122
Deficit for the year after tax		(486)	(592)
Surplus for the year transferred to accumulated income in endowment funds	15	1,374	1,374
Surplus for the year retained within general reserves		888	782

Balance sheets

as at 31 July 2011

	Notes	Consolidated 2011 £'000	Consolidated 2010 £'000	London Business School 2011 £'000	London Business School 2010 £'000
FIXED ASSETS					
Tangible assets	10	76,067	68,425	76,028	68,386
Other investments	11	10,210	12,364	201	91
Investment in associate company	11	252	136	–	–
		86,529	80,925	76,229	68,477
ENDOWMENT ASSETS	11	24,035	19,548	–	–
CURRENT ASSETS					
Stock		105	56	105	56
Debtors	12	9,930	10,010	5,430	16,524
Cash at bank and in hand		6,116	1,900	5,336	557
		16,151	11,966	10,871	17,137
Creditors: amounts falling due within one year	13	(36,950)	(35,736)	(35,646)	(40,606)
Net current liabilities		(20,799)	(23,770)	(24,775)	(23,469)
Total assets less current liabilities		89,765	76,703	51,454	45,008
Creditors: amounts falling due after more than one year	14	(532)	(550)	(532)	(550)
Net assets excluding pension liability		89,233	76,153	50,922	44,458
Net pension liability	20	(4,407)	(4,413)	(4,407)	(4,413)
Net assets including pension liability		84,826	71,740	46,515	40,045
ENDOWMENTS					
Expendable	15	6,413	5,423	–	–
Permanent	15	17,622	14,125	–	–
Reserves					
General		9,355	7,641	(4,922)	(4,506)
Pension	20	(4,407)	(4,413)	(4,407)	(4,413)
Revaluation		32,143	24,218	32,143	24,218
Total	16	61,126	46,994	22,814	15,299
Deferred capital grants	17	23,700	24,746	23,701	24,746
Total funds		84,826	71,740	46,515	40,045

10 Tangible assets

CONSOLIDATION	Land and Buildings Freehold	Long leasehold	Assets in course of construction	Facility improve-ments	Furniture and equipment	Total
COST OR VALUATION	£'000	£'000	£'000	£'000	£'000	£'000
At 1 August 2010	17,379	41,500	3,390	8,246	6,163	76,678
Additions	–	–	4,449	20	844	5,313
Transfer from AICC	–	–	(254)	254	–	–
Transfers	5,460	2,085	–	(7,545)	–	–
Revaluation	(2,989)	3,415	–	–	–	426
At 31 July 2011	19,850	47,000	7,585	975	7,007	82,417
DEPRECIATION						
At 1 August 2010	372	1,913	–	1,194	4,774	8,253
Charges for the year	372	1,913	–	848	903	4,036
Transfers	962	407	–	(1,369)	–	–
Revaluation	(1,706)	(4,233)	–	–	–	(5,939)
At 31 July 2011	–	–	–	673	5,677	6,350
NET BOOK VALUE						
Balance at 31 July 2011	19,850	47,000	7,585	302	1,330	76,067
Balance at 31 July 2010	17,007	39,587	3,390	7,052	1,389	68,425

On 31 July 2011 the freehold and long leasehold land and buildings were re-valued at £68.3 million on the basis of existing use value by Drivers Jonas, Chartered Surveyors. This includes £1.5m for one property which is currently recorded under assets in the course of construction.

The School does not ordinarily capitalise its heritage assets. Within the Anniversary Trust one heritage asset has been capitalised, at the value on the date the piece was acquired. In addition, the School has been gifted a number of other items of artwork considered to be heritage assets but has not capitalised these as in aggregate they are not deemed to be of sufficient material value to affect the presentation of the financial statements. The total insurance value of these items is £300,000.

(h) Fixed assets

All fixed assets costing more than £3,000 are capitalised. All assets are stated at cost or in the case of freehold/leasehold at valuation. All assets are depreciated in line with their expected useful lives using the straight line method at the following rates:

	Annual rates of depreciation
Land	no depreciation
Freehold buildings	2%
Leasehold buildings	period of lease
Facility improvements	10%
Furniture, fittings and equipment	20-25%
Computer equipment	33%

A full month's depreciation is charged in the month of purchase and no depreciation is charged in the year of disposal. Any gains and losses on disposals of fixed assets are reflected in the income and expenditure account in the year in which they occur. Assets in the course of construction are accounted for at cost and are capitalised as incurred but are depreciated only when the individual asset is operational.

Part III: Shareholders' Equity (10 points)

We are given the following worksheet about Dalek Corp. at the end of 2010. Notice that this is not a transaction worksheet but a simplified version of the statement of shareholders' equity. Please answer the short questions on the next page based on the information provided here. (Numbers suffice, you do not need to provide any explanations.)

	Common Stock				Treasury Stock		TOTAL
	# Shares	Par value	Share premium	Retained earnings	# Shares	Amount	
Beginning balance	50,000	50,000	140,000	65,000	3,500	(7,000)	248,000
Shares issued	20,000	20,000	54,000				74,000
Net income				86,500			86,500
Dividends declared				(12,800)			(12,800)
Shares repurchased					1,250	(5,000)	(5,000)
Shares re-issued			2,250		(1,000)	2,000	4,250
Ending balance	70,000	70,000	196,250	138,700	3,750	(10,000)	394,950

i. What is Dalek's earnings in 2010?

Assuming earning means income, $ 86,500

ii. What is the total dollar amount of dividends declared?

$ 12,800

iii. If beginning dividends payable is $100 and ending dividends payable is $200. How much dividends are paid out in cash?

100+12800-200= $ 12,700

iv. What is the par value of a share of common stock?

$ 1

v. What price did they issue new shares of common stock at?

74000/20000= $ 3.7

vi. How many shares did Dalek repurchase?

1,250 shares

vii. At what price did Dalek resell treasury stock?

4250/1000= $ 4.25

viii. How many shares are outstanding on 12/31/2010?

73,750 shares