Question #1 of 155

Question ID: 1457361

Royster Company presents the following income statement:

Sales	$12,000
Cost of goods sold	$6,000
Selling and administrative expense	$1,200
Interest expense	$600
Pretax income	$4,200
Income tax expense	$1,470
Net income	$2,730

Which of the following line items would appear on a common-size income statement for this period?

A) Pretax income 35%.

B) Income tax expense 54%.

C) Net income 65%.

Explanation

Common-size income statements express each line item as a percentage of sales.

Sales	100%
Cost of goods sold	50%
Selling and administrative expense	10%
Interest expense	5%
Pretax income	35%
Income tax expense	12.25%
Net income	22.75%

(Module 18.5, LOS 18.i)

Question #2 of 155

Question ID: 1457339

Antidilutive securities should be assumed to have been converted to common shares when calculating:

A) basic EPS but not diluted EPS.

B) diluted EPS but not basic EPS.

C) neither basic nor diluted EPS.

Explanation

Antidilutive securities would increase EPS if exercised or converted to common stock. Therefore we do not assume they are converted when we calculate diluted EPS. Basic EPS is calculated before assuming any potentially dilutive securities are converted.

(Module 18.4, LOS 18.h)

Question #3 of 155

Question ID: 1457296

At the beginning of the year, BJC Company had 40,000 shares of $1 par common stock outstanding. On April 1, BJC issued a 2-for-1 stock split and on July 1, BJC reacquired 20,000 shares. On October 1, BJC issued 8,000 shares of $10 par, 5% cumulative preferred stock. How many shares should BJC use to calculate diluted earnings per share?

A) 60,000.

B) 62,000.

C) 70,000.

Explanation

The stock split is applied from the beginning of the year. Because the preferred stock is not convertible, it has no impact on the number of common shares for calculating diluted EPS. Beginning shares (40,000 shares × 12 months) + split shares (40,000 shares × 12 months) − reacquired shares (20,000 shares × 6 months) = 840,000, and 840,000 / 12 months = 70,000 shares.

(Module 18.4, LOS 18.g)

Question #4 of 155

Question ID: 1457262

The following data pertains to the McGuire Company:

- Net income equals $15,000.
- 5,000 shares of common stock issued on January 1.
- 10% stock dividend issued on June 1.
- 1000 shares of common stock were repurchased on July 1.
- 1000 shares of 10%, par $100 preferred stock each convertible into 8 shares of common were outstanding the whole year.

What is the company's basic earnings per share (EPS)?

A) $2.50.

B) $1.20.

C) $1.00.

Explanation

Number of average shares:

1/1 5,500 shares issued (includes 10% stock dividend on 6/1) × 12 = 66,000

7/1 1,000 shares repurchased × 6 months = 6,000

66,000 − 6,000 = 60,000

60,000 shares / 12 months = 5,000 average shares

Preferred dividends = ($10)($1,000) = $10,000

Basic EPS = [$15,000(NI) – $10,000(preferred dividends)] / 5,000 shares = $5,000 / 5,000 shares = $1/share

(Module 18.4, LOS 18.g)

Question #5 of 155

Question ID: 1457303

Firewalz, Inc., had 500,000 shares of common stock and 20,000 shares of 6%, $100 par preferred stock outstanding at the beginning of the year. Each share of the preferred can be converted into two shares of common stock. On July 1, the company repurchased 100,000 shares of its common stock. If net income for the year is $1.2 million, the reported diluted EPS for the year is *closest* to:

A) $2.42.

B) $2.45.

C) $2.40.

Explanation

Preferred dividends = 6% × $100 × 20,000 = $120,000.

Basic EPS = ($1.2 million – $120,000) / [500,000 – (0.5)100,000] = $2.40.

The preferred dividend per common share that results from conversion = $120,000 / (2 × 20,000) = $3.00, which is greater than $2.40. The preferred is antidilutive (conversion would not reduce EPS). Therefore, reported diluted EPS will be the same as basic EPS: $2.40.

(Module 18.4, LOS 18.g)

Question #6 of 155

Question ID: 1457221

During 2007, Topeka Corporation entered into the following transactions:

> Transaction #1 – Interest on a certificate of deposit owned by Topeka was credited to Topeka's investment account.
>
> Transaction #2 – Topeka sold 10,000 shares of common stock at $30 that had been repurchased by Topeka last year for $20.

Should Topeka recognize the results of these transactions as income on the income statement for the year ended December 31, 2007?

A) Both should be recognized. ✗

B) Neither should be recognized. ✗

C) Only one should be recognized. ✓

Explanation

Interest earned on the CD is recognized as interest income. The gain on the sale of treasury stock is not reported on the income statement but is reflected on the statement of changes in stockholders' equity and on the balance sheet. The sale proceeds simply increase equity and increase cash.

(Module 18.1, LOS 18.a)

Question #7 of 155

Question ID: 1457364

An analyst prepares the following common-size income statements for Perez Company:

	20X1	20X2	20X3
Sales	100%	100%	100%
Cost of goods sold	50%	52%	53%
Selling and administrative expense	16%	12%	9%
Interest income	4%	4%	4%
Pretax income	30%	32%	34%
Income tax expense	15%	16%	17%
Net income	15%	16%	17%

Based only on this information, Perez's improving net profit margin is *most likely* a result of:

A) greater financial leverage.

B) controlling operating expenses.

C) improving gross margins.

Explanation

The improvement in net profit margin from 15% to 17% appears to result mainly from the firm reducing selling and administrative expense from 16% of sales to 9% of sales, thus decreasing operating expenses from 66% to 62% of sales. Gross margin is decreasing over this period because cost of goods sold is increasing as a percentage of sales. While financial leverage cannot be determined directly from the income statement, the fact that interest expense is a constant percentage of sales suggests financial leverage is stable.

(Module 18.5, LOS 18.j)

Question #8 of 155

Question ID: 1457240

Changes in asset lives and salvage values are changes in accounting:

A) principle and are applied retrospectively.

B) estimates and are applied retrospectively.

C) estimates and are applied prospectively. ✓

Explanation

Changes in asset lives and salvage value are changes in accounting estimates and are not considered changes in accounting principle. Changes in accounting estimates are applied prospectively.

(Module 18.3, LOS 18.e)

Question #9 of 155

Question ID: 1457306

Stanley Corp. had 100,000 shares of common stock outstanding throughout 2004. It also had 20,000 stock options with an exercise price of $20 and another 20,000 options with an exercise price of $28. The average market price for the company's stock was $25 throughout the year. The stock closed at $30 on December 31, 2004. What are the number of shares used to calculate diluted earnings per share for the year?

A) 110,000. ✗

B) 104,000. ✓

C) 105,000. ✗

Explanation

Only the stock options with an exercise price of $20 are dilutive. The additional shares of 4,000 (20,000 − [(20,000 × 20) / 25]) are added to the 100,000 common shares outstanding.

(Module 18.4, LOS 18.h)

Question #10 of 155

Question ID: 1457323

Zachary Company's warrants issued in 2000 are Zachary's only outstanding potentially dilutive security. In 2005, EPS and Dilutive EPS differed for the first time. A possible explanation for the change is the:

A) average market price of Zachary decreased. ✗

B) average market price of Zachary increased. ✓

C) year-end market price of Zachary increased. ✗

Explanation

An increase in average market price could cause Zachary's warrants to go from antidilutive to dilutive. If the average price of the stock increases during the year, the warrants are likely to be exercised at some point during the year. Neither of the other choices would do this.

(Module 18.4, LOS 18.h)

Question #11 of 155

Question ID: 1457366

Matrix, Inc.'s common size income statement for the years ended December 31, 20X1 and 20X2 included the following information (percent of net sales):

	20X1	20X2
Sales	100	100
Cost of Goods Sold	(55)	(60)
	45	40
Selling General & Administrative	(5)	(5)
Depreciation	(7)	(8)
	33	27
Interest Expense	(15)	(6)
	18	21
Income Tax Expense	(6)	(7)
	12	14

Analysis of this data indicates that from 20X1 to 20X2:

A) cost of goods sold increased.

B) interest expense per dollar of sales declined.

C) the effective tax rate increased.

Explanation

On a common size income statement, all amounts are stated as a percentage of sales. Interest expense per dollar of sales has declined from 0.15 to 0.06. The other interpretations listed are not necessarily correct. COGS increased as a percentage of sales, but if sales decreased, COGS may have decreased as well. The company's effective tax rate (income tax expense / pretax income) can be calculated from a common-size income statement. Here the effective tax rate was 33% in both years.

(Module 18.5, LOS 18.j)

Question #12 of 155

Question ID: 1457338

How will dilutive securities affect earnings per share (EPS) when determining diluted earnings per share?

A) Increase EPS.

B) Decrease EPS.

C) Either decrease or increase EPS depending upon if the security is dilutive or antidilutive.

Explanation

Dilutive securities such as convertibles and options are found in a complex capital structure and always decrease EPS. Convertibles and options may also be antidilutive, which will increase EPS hence the name antidilutive. The only way to know if a security is dilutive or antidilutive is to compare the basic EPS to diluted EPS. If the diluted EPS is higher than the basic EPS then the security is antidilutive and should not be included when determining diluted EPS.

(Module 18.4, LOS 18.h)

Question #13 of 155

Question ID: 1457225

According to the standards for revenue recognition, a promise to transfer a distinct good or service is *most accurately* described as a:

A) contract.

B) performance obligation.

C) transaction.

Explanation

Performance obligations within a contract are defined as promises to transfer distinct goods or services.

(Module 18.2, LOS 18.b)

Question #14 of 155

Question ID: 1457349

Selected information from Doors, Inc.'s financial activities in the year 2005 included the following:

- Net income was $372,000.
- 100,000 shares of common stock were outstanding on January 1.
- The average market price per share was $18 in 2005.
- Dividends were paid in 2005.
- 2,000, 6 percent $1,000 par value convertible bonds, which are convertible at a ratio of 25 shares for each bond, were outstanding the entire year.
- Doors, Inc.'s tax rate is 40%.

Doors, Inc.'s diluted earnings per share (Diluted EPS) for 2005 was *closest* to:

A) $2.96. ✓

B) $3.28. ✗

C) $3.72. ✗

Explanation

Doors basic earnings per share (EPS) was ($372,000 / 100,000 =) $3.72. If the bonds were converted, interest payments would not have been made. Net income is increased by the interest paid on the bonds net of taxes: $372,000 + (($1000 × 2,000 × 0.06) × (1 − 0.40)) = $444,000.

Diluted EPS was $444,000 / (100,000 + (2,000 × 25)) = $2.96.

(Module 18.4, LOS 18.h)

Question #15 of 155

Question ID: 1457239

Which of the following statements regarding making changes in accounting principles is *least* accurate?

A) The general rule is retrospective application.

B) A change in accounting principle is a change from one generally accepted accounting principle to another generally accepted principle. The firm making the change must justify the change.

C) Changes in accounting estimates are now treated the same as changes in accounting principles.

Explanation

Changes in accounting estimates are not treated the same as changes in principles. Changes in principles are treated retrospectively, whereas changes in accounting estimates are accounted for in the current and future periods. Both remaining statements are accurate.

(Module 18.3, LOS 18.e)

Question #16 of 155

Question ID: 1457265

An analyst has gathered the following information about a company:

- 110,000 shares of common outstanding at the beginning of the year.
- The company repurchases 20,000 of its own common shares on July 1.
- Net income is $300,000 for the year.
- 10,000 shares of existing 10 percent cumulative $100 par preferred outstanding that is not in arrears at the beginning or ending of the year.
- The company also has $1 million in 10 percent callable bonds outstanding.
- The company has declared a $0.50 dividend on the common.

What is the company's basic Earnings Per Share?

A) $1.00.

B) $2.00.

C) $3.00.

Explanation

Interest is already deducted from earnings.

$$\frac{300{,}000-(0.10)(\$100)(10{,}000)}{110{,}000-(6/12)(20{,}000)}=\$2.00$$

(Module 18.4, LOS 18.g)

Question #17 of 155

Question ID: 1457312

Assume that the exercise price of an option is $6, and the average market price of the stock is $10. Assuming 802 options are outstanding during the entire year, the number of shares to be added to the denominator of diluted earnings per share (EPS) is *closest* to:

A) 802. ✗

B) 481. ✗

C) 321. ✓

Explanation

Proceeds from the exercise of the options would be:

(802)($6) = $4,812

The number of shares that could be repurchased with the proceeds at the average price is:

4,812 / 10 = 481.2

The additional number of shares the company would need to issue to fulfill the stock options is:

802 − 481 = 321

(Module 18.4, LOS 18.h)

Question #18 of 155

Question ID: 1457278

A firm with a capital structure consisting of only common stock and non-convertible bonds is said to have a:

A) simple capital structure. ✓

B) non-diluted capital structure. ✗

C) straight capital structure. ✗

Explanation

A *simple capital structure* is one that contains *no* securities that have the potential to dilute a firm's earnings per share. For example, convertible bonds, convertible preferred stock, options, and warrants have the potential to dilute earnings per share upon conversion or exercise.

(Module 18.4, LOS 18.g)

Question #19 of 155

Question ID: 1457362

To convert an income statement to a vertical common-size income statement, each line item should be stated as a percentage of:

A) pretax income. ✗

B) revenue. ✓

C) net income. ✗

Explanation

A vertical common-size income statement states each item as a percentage of revenue.

(Module 18.5, LOS 18.i)

Question #20 of 155

Question ID: 1457244

Pinto Corporation is an automobile manufacturer located in North America. Pinto owns a 5 percent interest in one of its suppliers, Continental Supply Company. Each year, Pinto receives a cash dividend from Continental. Pinto's engine supplier, National Supply Company, recently increased prices on goods sold to all customers due to higher labor costs. Should Pinto report the dividends received from Continental and the price increase from National as an operating or nonoperating component on its year-end income statement?

A) Only one is operating. ✓

B) Both are nonoperating. ✗

C) Both are operating. ✗

Explanation

Since Pinto is a nonfinancial firm, dividends received would be considered a nonoperating component. An increase in cost of goods sold would be considered a part of normal operations.

(Module 18.3, LOS 18.f)

Question #21 of 155

Question ID: 1457228

The JME Jumpers, a professional volleyball team, sells season tickets to all home games. The cost of a season ticket is $1,000 and the team plays 20 home games, which run from April through August. For the year ended June 30, 2005, JME sold 1,200 tickets, collected 80 percent of the amount owed, and played 12 home games. How much revenue should JME recognize?

A) $720,000. ✓

B) $960,000. ✗

C) $1,200,000. ✗

Explanation

(1,200 × $1,000 × 12/20) = $720,000

(Module 18.2, LOS 18.c)

Question #22 of 155

Question ID: 1457226

The approach to revenue recognition in the converged accounting standards that were issued in May 2014 is *best* described as:

A) objectives-based. ✗

B) principles-based. ✓

C) rules-based. ✗

Explanation

The converged accounting standards concerning revenue recognition, issued in May 2014 by the IASB and FASB, are principles-based.

(Module 18.2, LOS 18.b)

Question #23 of 155

Question ID: 1457313

Assume that the exercise price of an option is $9, and the average market price of the stock is $12. Assuming 992 options are outstanding during the entire year, what is the number of shares to be added to the denominator of the Diluted EPS?

A) 248.

B) 744.

C) 992.

Explanation

(992)($9) = $8928

$8928 / 12 = 744

992 − 744 = 248 new shares or [(12 − 9) / 12]992 = 248

(Module 18.4, LOS 18.h)

Question #24 of 155

Question ID: 1462810

An analyst gathers the following data about a company:

- The company had 1 million shares of common stock outstanding for the entire year.
- The company's beginning stock price was $50, its ending price was $70, and its average price was $60.
- The company had 100,000 warrants outstanding for the entire year. Each warrant allows the holder to buy one share of common stock at $50 per share.

How many shares of common stock should the company use in computing its diluted earnings per share?

A) 1,016,667.

B) 1,083,333.

C) 1,100,000.

Explanation

Use the Treasury stock method:

Step 1:	Determine the number of common shares created if the warrants are exercised = 100,000.
Step 2:	Calculate the cash inflow if the warrants are exercised: (100,000)($50 per share) = $5,000,000.
Step 3:	Calculate the number of shares that can be purchased with these funds using the average market price ($60 per share): 5,000,000 / 60 = 83,333 shares.
Step 4:	Calculate the net increase in common shares outstanding from the exercise of the warrants: 100,000 − 83,333 = 16,667.
Step 5:	Add the net increase in common shares from the exercise of the warrants to the number of common shares outstanding for the entire year: 1,000,000 + 16,667 = 1,016,667.

(Module 18.4, LOS 18.g)

Question #25 of 155

Question ID: 1457360

BWT, Inc. shows the following data in its financial statements at the end of the year. Assume all securities were outstanding for the entire year.

- 6.125% convertible bonds, convertible into 33 shares of common stock. Issue price $1,000, 100 bonds outstanding.
- 6.25% convertible preferred stock, $100 par, 2,315 shares outstanding. Convertible into 3.3 shares of common stock, Issue price $100.
- 8% convertible preferred stock, $100 par, 2,572 shares outstanding. Convertible into 5 common shares, Issue price $80.
- 9,986 warrants are outstanding with an exercise price of $38. Each warrant is convertible into 1 share of common. Average market price of common is $52.00 per share.
- Common shares outstanding at the beginning of the year were 40,045.
- Net Income for the period was $200,000, while the tax rate was 40%.

What are the basic and diluted EPS for the year?

	Basic EPS	Diluted EPS	
A)	$4.12	$2.95	✗
B)	$3.97	$3.06	✗

C) $4.12 $3.06

Explanation

Basic EPS = Net income – preferred dividends / Weighted average shares of common

Preferred dividends:

- 6.25% convertible preferred stock:

  (0.0625)($100)(2,315) = $14,469

- 8% convertible preferred stock:

  (0.08)($100)(2,572) = $20,576

- Preferred dividends = $14,469 + $20,576 = $35,045.

Basic EPS = ($200,000 – $35,045) / 40,045 = 164,955/40,045 = $4.12

Diluted EPS:

First, check each of the potentially dilutive securities for dilution.

- 6.125% convertible bonds:

  (Convertible debt interest)(1 – tax rate) / Common shares if converted

  = (0.06125)($1,000)(100)(1 – 0.4) / (33)(100)

  = $1.1136

  Because this is less than basic EPS, these convertible bonds are dilutive.

- 6.25% convertible preferred stock:

  Preferred dividend / Common shares if converted

  = (0.0625)($100) / 3.3 = $1.8939

  Because this is less than basic EPS, this convertible preferred stock is dilutive.

- 8% convertible preferred stock:

  Preferred dividend / Common shares if converted

  = (0.08)($100) / 5 = $1.60

  Because this is less than basic EPS, this convertible preferred stock is dilutive.

- Warrants:

  Because the exercise price $38 is less than average share price $52, the warrants are dilutive.

Next, determine the number of common shares that would be created by exercise of each dilutive security:

- 6.125% convertible bonds:

  (100 bonds)(33) = 3,300 common shares

- 6.25% convertible preferred stock:

  (2,315 preferred shares)(3.3) = 7,640 common shares

- 8% convertible preferred stock:

(2,572 preferred shares)(5) = 12,860 common shares

- Warrants:

  [($52 – $38) / $52] × 9,986 = 2,689 common shares

Diluted EPS = (Net income − preferred dividends + convertible preferred dividends + after-tax convertible debt interest) / Weighted average shares of common adjusted for exercise [($200,000 − $35,045) + $35,045 + (0.06125)($1,000)(100)(1 − 0.4)] / (40,045 + 3,300 + 7,640 + 12,860 + 2,689) = $203,675 / 66,534 shares = $3.06

(Module 18.4, LOS 18.h)

Question #26 of 155

Question ID: 1462814

Using the following information for Boxes, Inc.:

- Net income $53,000,000
- Outstanding 7% preferred stock, par value $30,000,000
- Outstanding convertible bonds, face value of $10,000,000, Issued on January 1 at par with a coupon rate of 6% and convertible at the rate of 20 shares per 1,000 of face value
- 100,000 options at 55 outstanding all year
- Tax rate 30%
- 3,000,000 common shares outstanding all year
- Stock price 60 at year-end, average stock price over the year 50.

Diluted EPS is *closest* to:

A) $15.00. ✗

B) $16.00. ✓

C) $17.00. ✗

Explanation

Basic EPS = $\dfrac{53{,}000{,}000-(0.07\times30{,}000{,}000)}{3{,}000{,}000}=\$16.97$

The options are not dilutive because the exercise price is greater than the average price over the period.

Diluted EPS = $\dfrac{53{,}000{,}000-(0.07\times30{,}000{,}000)+[10{,}000{,}000\times0.06\times(1-0.30)]}{3{,}000{,}000+200{,}000}=\$16.04$

(Module 18.4, LOS 18.h)

Question #27 of 155

Question ID: 1457344

Orange Company's net income for 2004 was $7,600,000 with 2,000,000 shares outstanding. The average share price in 2004 was $55. Orange had 10,000 shares of eight percent $1,000 par value convertible preferred stock outstanding since 2003. Each preferred share was convertible into 20 shares of common stock. Orange Company's diluted earnings per share (Diluted EPS) for 2004 is *closest* to:

A) $3.40. ✓

B) $3.45. ✗

C) $3.80. ✗

Explanation

Orange's basic EPS ((net income – preferred dividends) / weighted average common shares outstanding) is [($7,600,000 − (10,000 × $1,000 × 0.08)] / 2,000,000 = $3.40. To check for dilution, EPS is calculated under the assumption that the convertible preferred shares are converted into common shares at the beginning of the year. The preferred dividends paid are added back to the numerator of the Diluted EPS equation, and the additional common shares are added to the denominator of the equation. Orange's if-converted EPS is $7,600,000 / (2,000,000 + 200,000) = $3.45. Because if-converted EPS is higher than basic EPS, the preferred stock is antidilutive and no adjustment is made to basic EPS.

(Module 18.4, LOS 18.h)

Question #28 of 155

Question ID: 1457371

Is an acquisition of treasury stock or a loss from the write-down of inventory under the lower-of-cost-or-market rule included in comprehensive income?

	Inventory write-down	Acquisition of treasury stock	
A)	No	No	✗
B)	No	Yes	✗
C)	Yes	No	✓

Explanation

Comprehensive income includes all transactions that affect shareholders' equity except transactions with shareholders. Thus, any transaction that affects net income would also affect comprehensive income. Since the inventory write-down is included in net income, it is part of comprehensive income. The acquisition of treasury stock is a transaction with shareholders; thus, it is not a part of comprehensive income.

(Module 18.5, LOS 18.k)

Question #29 of 155

Question ID: 1457259

Washington, Inc.'s stock transactions during the year 20X4 were as follows:

January 1	720,000 shares issued and outstanding
May 1	2 for 1 stock split occurred

What was Washington's weighted average number of shares outstanding during 20X4, for earnings per share (EPS) computation purposes?

A) 1,440,000.

B) 1,500,000.

C) 1,666,667.

Explanation

The January 1 balance is adjusted retroactively for the stock split and (720,000 × 2 =) 1,440,000 shares are treated as outstanding from January.

(Module 18.4, LOS 18.g)

Question #30 of 155

Question ID: 1462805

Which costs are *least likely* to be reported as an expense in the current accounting period?

A) Period costs.

B) Loan interest that has not yet been paid.

C) Costs of producing inventory.

Explanation

Inventory costs are expensed when items are sold under the matching principle. As an extreme example, if no sales are made, no costs of inventory production are expensed for the period. Period costs are expensed during the period. Under the accrual method, interest accrued during the period is expensed, regardless of whether it has been paid during the period. (Module 18.3, LOS 18.d)

Question #31 of 155

Question ID: 1457327

Nichols Company's net income for 20X6 was $978,000 with 1,250,000 shares outstanding. The average share price in 20X6 was $8.50. Nichols issued 2,000 warrants to purchase 100 shares each for $10 per share in 20X5. Nichols Company's diluted earnings per share (diluted EPS) for 20X6 is *closest* to:

A) $0.782.

B) $0.777.

C) $0.793.

Explanation

Nichols basic EPS (net income / weighted average common shares outstanding) was:

$978,000 / 1,250,000 = $0.782.

Because the exercise price of the warrants is higher than the average share price, the warrants are antidilutive and are excluded from diluted EPS. Because there were no other potentially dilutive securities, Nichols' diluted EPS in 20X6 is the same as basic EPS.

(Module 18.4, LOS 18.h)

Question #32 of 155

Question ID: 1457326

Selected information from Indigo Corp.'s financial activities in the year 20X9 included the following:

- Net income is $5,600,000.
- The tax rate is 40%.
- 500,000 shares of common stock were outstanding on January 1.
- The average market price per share was $82 in 20X9.
- 6,000 5% coupon $1,000 par value convertible bonds, which are convertible at a ratio of 20 shares for each bond, were outstanding the entire year.
- 200,000 shares of common stock were issued on July 1.
- 100,000 shares of common stock were purchased by the company as treasury stock on October 1.

Indigo Corp.'s diluted earnings per share for 20X9 are *closest* to:

A) $8.32. ✓

B) $8.49. ✗

C) $9.74. ✗

Explanation

Indigo's weighted average common shares = [(500,000 × 12) + (200,000 × 6) – (100,000 × 3)] / 12 = 575,000. Basic EPS = $5,600,000 / 575,000 = $9.74.

For diluted EPS, assume the bonds were converted on January 1, and that interest payments were not made on the bonds. Increasing net income by the amount of bond interest net of tax = $5,600,000 + [6,000 × $1,000 × 0.05 × (1 − 0.40)] = $5,780,000. Diluted EPS = $5,780,000 / (575,000 + 120,000) = $8.32.

(Module 18.4, LOS 18.h)

Question #33 of 155

Question ID: 1457374

Where in the financial statements should a firm recognize the unrealized gains and losses on cash flow hedging derivatives and the unrealized gains and losses on available-for-sale securities?

	Cash flow hedging derivatives	Available-for-sale securities	
A)	Other comprehensive income	Other comprehensive income	✓
B)	Net income	Other comprehensive income	✗

C) Other comprehensive income Net income

Explanation

Unrealized gains and losses from cash flow hedging derivatives and unrealized gains and losses from available-for-sale securities are not recognized in the income statement; rather, they are both recognized as a component of stockholders' equity as a part of other comprehensive income.

(Module 18.5, LOS 18.l)

Question #34 of 155

Question ID: 1457286

Oregon Corp.'s stock transactions during the year were as follows:

- January 1: 320,000 shares outstanding.
- April 1: 1-for-2 reverse stock split occurred.
- July 1: Acquisition of Smith, Inc. in exchange for issuance of 60,000 shares.
- October 1: 30,000 shares issued for cash.

What is Oregon's weighted average number of shares outstanding?

A) 250,000.

B) 167,500.

C) 197,500.

Explanation

The January 1 balance is adjusted retroactively for the reverse stock split and 320,000 / 2 = 160,000 shares are treated as outstanding from January 1. Issuance of stock is included from the date of issuance. The weighted average shares are computed by multiplying the share amounts by the number of months the shares were outstanding, then adding these amounts and dividing the sum by 12.

January 1:	initial shares	160,000 × 12 =	1,920,000
July 1:	Smith acquisition	60,000 × 6 =	360,000
October 1:	cash issuance	30,000 × 3 =	90,000
Total:			2,370,000

Oregon's weighted average shares = 2,370,000 / 12 = 197,500.

(Module 18.4, LOS 18.g)

Question #35 of 155

Question ID: 1457350

Based on the following data, how many shares of common stock should be used to calculate diluted earnings per share?

- Net income of $1,500,000, tax retention rate of 60%.
- 1,000,000 shares of common are outstanding at the beginning of the year.
- 10,000, 6% convertible bonds with each bond convertible into 20 shares of common stock were issued at par ($100) on June 30th of this year.
- The firm has 100,000 warrants outstanding all year with an exercise price of $25 per share.
- The average stock price for the period is $20, and the ending stock price is $30.

A) 1,100,000. ✓

B) 1,000,000. ✗

C) 1,266,667. ✗

Explanation

First, Check for dilution: Basic EPS = 1,500,000 / 1,000,000 = 1.50

Warrants: anti-dilutive since the average stock price is less than the exercise price

Convertible bonds: **numerator impact** = (# bonds) × (par value) × (interest rate) × (tax retention rate) × (0.5 for 1/2 year outstanding) = (10,000) × (100) × (0.06) × (0.6) × (0.5) = 18,000, so the numerator = 1,518,000 **Denominator impact:** increase in average shares = [(# bonds) × (conversion factor) × (# months outstanding)] / 12 = (1,200,000 / 12 = 100,000) so, the denominator = 1,100,000 and EPS with conversion = 1,518,000 / 1,100,000 = 1.38, which is less than 1.50. The bonds are dilutive and the diluted EPS calculation should use 1,100,000 shares of common stock in the denominator. The warrants are out of the money based on the average price of $20.

(Module 18.4, LOS 18.h)

Question #36 of 155

Question ID: 1457363

Which of the following data are *least likely* to be read directly from a common-size income statement?

A) Effective tax rate. ✓

B) Net profit margin. ✗

C) Ratio of SG&A expense to sales. ✗

Explanation

The effective tax rate is income tax expense as a percentage of pretax income. Items on a common-size income statement are stated as a percentage of revenue (sales). Net profit margin is net income as a percentage of revenue.

(Module 18.5, LOS 18.i)

Question #37 of 155

Question ID: 1457308

When considering the impact of warrants on earnings per share, the method to calculate the number of shares added to the denominator is derived using which method?

A) Treasury Stock method. ✓

B) Weighted average method. ✗

C) Cost recovery method. ✗

Explanation

The treasury stock method assumes the hypothetical funds received by the company from the exercise of the options are used to purchase shares of the company's common stock in the market at the average market price.

(Module 18.4, LOS 18.h)

Question #38 of 155

Question ID: 1457242

Retrospective presentation is *least likely* required for a change from:

A) LIFO to average cost inventory valuation. ✗

B) percentage-of-completion to completed contract revenue recognition. ✗

C) zero salvage value to positive salvage value. ✓

Explanation

Changes in accounting principle require retrospective presentation. A change in the salvage value of an asset is a change in accounting estimate, which does not apply retrospectively.

(Module 18.3, LOS 18.e)

Question #39 of 155

Question ID: 1457335

In calculating the numerator for diluted earnings per share, the dividends on convertible preferred stock (if it is dilutive) are:

A) added to earnings available to common shareholders without an adjustment for taxes. ✓

B) added to earnings available to common shareholders with an adjustment for taxes. ✗

C) subtracted from earnings available to common shareholders without an adjustment for taxes. ✗

Explanation

Diluted EPS = [(Net income − Preferred dividends) + Convertible preferred dividends + (Convertible debt interest)(1 − t)] / [(Weighted average shares) + (Shares from conversion of conv. pfd shares) + (Shares from conversion of conv. debt) + (Shares issuable from stock options)]

(Module 18.4, LOS 18.h)

Question #40 of 155

Question ID: 1457290

During 2004, Covax Corp. reported net income of $2.4 million and 2 million shares of common stock. Covax paid cash dividends of $14,000 to its preferred shareholders and $30,000 to its common shareholders. In 2004, Covax issued 900, $1,000 par, 5.5 percent bonds for $900,000. Each bond is convertible to 50 shares of common stock. Assume the tax rate is 40%. Compute Covax's basic and diluted EPS.

	Basic EPS	Diluted EPS	
A)	$1.19	$1.18	✓
B)	$1.19	$1.22	✗
C)	$1.22	$1.22	✗

Explanation

2004 Basic EPS:

$$\text{Basic EPS} = \frac{2{,}400{,}000 - 14{,}000}{2{,}000{,}000} = \$1.19$$

2004 Diluted EPS:

$$\text{Diluted EPS} = \frac{(2{,}400{,}000 - 14{,}000) + (49{,}500)(1 - 0.40)}{(2{,}000{,}000) + (45{,}000)} = \$1.18$$

(Module 18.4, LOS 18.g)

Question #41 of 155

Question ID: 1457256

Last year, the AKB Company had net income equal to $5 million. Combined state and local taxes were 45%. The firm paid $1 million to holders of its 1 million common shares and $250,000 to 100,000 preferred shareholders. What was AKB's earnings per share (EPS) last year?

A) $2.50.

B) $2.25.

C) $4.75.

Explanation

EPS = earnings available to common shareholders divided by the weighted average number of common shares outstanding. Earnings available to common shareholders is net income minus preferred dividends, or $4,750,000 (= $5 million – 250,000) for AKB.

(Module 18.4, LOS 18.g)

Question #42 of 155

Question ID: 1457365

Selected financial ratios from Mulroy Company's common-size income statements are as follows:

	20X1	20X2	20X3
Gross profit margin	22%	24%	26%
Operating profit margin	18%	20%	22%
Pretax margin	15%	14%	13%
Net profit margin	11%	10%	9%

Relative to sales, it is *most likely* that Mulroy's:

A) operating expenses are increasing.

B) nonoperating expenses are increasing.

C) income tax expense is increasing.

Explanation

Nonoperating expenses are equal to the difference between operating profit and pretax profit. Based on the given profit margins, Mulroy's nonoperating expenses increased from 3% of sales in 20X1 to 9% of sales in 20X3. Because gross profit margin is increasing, cost of goods sold is decreasing as a percentage of sales. Other operating expenses and income tax expense, as a percentage of sales, were stable over the period shown.

(Module 18.5, LOS 18.j)

Question #43 of 155

Question ID: 1457295

Roome Corp. has 5,000,000 common shares outstanding. There are 500,000 warrants outstanding to purchase the stock at $20, and there are 200,000 options outstanding to buy the stock at $50. The average market price for the stock over the year was $40, and the current stock price is $60. The number of shares used to calculate diluted EPS is:

A) 5,700,000 shares.

B) 5,300,000 shares.

C) 5,250,000 shares.

Explanation

Applying the treasury stock method to the warrants, 5,000,000 + [500,000 − (500,000 × $20) / $40] = 5,250,000 shares. The options are antidilutive because their exercise price is higher than the average stock price for the year.

(Module 18.4, LOS 18.g)

Question #44 of 155

Question ID: 1457254

An analyst gathered the following information about a company:

- 01/01/06 - 20,000 shares issued and outstanding
- 04/01/06 - 5.0% stock dividend
- 07/01/06 - 5,000 shares repurchased
- 10/01/06 - 2:1 stock split

What is the company's weighted average number of shares outstanding at the end of 2006?

A) 37,000.

B) 39,500.

C) 47,000.

Explanation

The end-of-period weighted average number of common shares outstanding is the number of shares outstanding during the year weighted by the portion of the year they were outstanding. Dividends and splits are applied to all shares issued or repurchased and all original or adjusted shares outstanding *prior* to the split or dividend.

Step 1) Apply the 04/01/06 dividend to the beginning of year shares:

Adjusted shares = 1.05 × 20,000 = 21,000

Step 2) Apply the 10/01/06 split to the adjusted beginning-of-year shares and the repurchase.

Adjusted beginning-of-year shares = 42,000 (= 2 × 21,000)

Adjusted repurchase = 10,000 (= 2 × 5,000)

Step 3) Compute the weighted average number of shares.

42,000(12/12) - 10,000(6/12) = 37,000 shares

(Module 18.4, LOS 18.g)

Question #45 of 155

Question ID: 1457337

In calculating the numerator for diluted Earnings Per Share, the interest on convertible debt is:

A) added to earnings available to common shareholders.

B) added to earnings available to common shareholders after an adjustment for taxes.

C) subtracted from earnings available to common shareholders after an adjustment for taxes.

Explanation

Formula = Diluted EPS = [(Net income − Preferred dividends) + Convertible preferred dividends + (Convertible debt interest)(1 − t)] / [(Weighted average shares) + (Shares from conversion of conv. pfd shares) + (Shares from conversion of conv. debt) + (Shares issuable from stock options)]

(Module 18.4, LOS 18.h)

Question #46 of 155

Question ID: 1457372

Are dividends paid to common shareholders and foreign currency translation gains and losses included in a firm's other comprehensive income?

	Dividends paid	Foreign currency translation gains and losses
A)	Yes	Yes
B)	No	Yes
C)	No	No

Explanation

Other comprehensive income includes non-owner transactions that affect shareholders' equity and are not recognized in net income. Dividends paid are transactions with the owners of the firm, so dividends paid are not included in other comprehensive income. Foreign currency translation gains and losses are non-owner transactions that are not recognized in net income. Thus, foreign currency translation gains and losses are included in other comprehensive income.

(Module 18.5, LOS 18.l)

Question #47 of 155

Question ID: 1457234

At the beginning of its first year of business, Digmore Corporation acquires a fixed asset for $90 million and estimates that it will have a useful life of eight years and a salvage value of $10 million. Digmore expects the asset to produce 150 million units of output over its life, including 30 million units in each of the first three years, 20 million units in each of years 4 to 7, and 10 million units in year 8. If depreciation expense in the first year is $10 million, what method of depreciation did Digmore *most likely* use?

A) Straight Line. ✓

B) Double-declining-balance. ✗

C) Units of production. ✗

Explanation

Using straight-line depreciation, the amount to be depreciated over the asset's life is $90 − $10 million = $80 million, and depreciation expense in each year is $80 million / 8 = $10 million.

If the firm had used double-declining balance, depreciation expense in the first year would have been 2/8 × $90 million = $22.5 million. Based on units of production, depreciation expense in the first year would have been (30 million / 150 million) × $80 million = $16 million.

(Module 18.3, LOS 18.d)

Question #48 of 155

Question ID: 1457358

Valuable Corp.'s basic earnings per share (EPS) and diluted EPS for the year are different. Given this information, which of the following statements is *least accurate*?

A) All of Valuable's potentially dilutive securities are antidilutive. ✓

B) Diluted EPS is less than basic EPS. ✗

C) Valuable Corp.'s capital structure may include both options and warrants.

Explanation

If all of Valuable's potentially dilutive securities were antidilutive, then EPS would equal diluted EPS.

(Module 18.4, LOS 18.h)

Question #49 of 155

Question ID: 1457347

Protocol, Inc.'s net income for 2005 was $4,800,000. Protocol had 800,000 shares of common stock outstanding for the entire year. The tax rate was 40 percent. The average share price in 2005 was $37.00. Protocol had 5,000 8 percent $1,000 par value convertible bonds that were issued in 2004. Each bond is convertible into 25 shares of common stock. Protocol, Inc.'s basic and diluted earnings per share for 2005 were *closest* to:

	Basic EPS	Diluted EPS
A)	$5.19	$4.92
B)	$6.00	$4.92
C)	$6.00	$5.45

Explanation

Protocol's basic EPS (net income / weighted average common shares outstanding) was $4,800,000 / 800,000 = $6.00. Diluted EPS is calculated under the assumption that the convertible bonds were converted into common stock, and the bond interest net of tax was restored to net income. The common shares from the conversion of the bonds are added to the denominator of the equation. Protocol's Diluted EPS was [$4,800,000 + (5,000 × $1,000 × 0.08)(1 − 0.40)] / [800,000 + (5,000 × 25)] = $5.45.

(Module 18.4, LOS 18.h)

Question #50 of 155

Question ID: 1457348

Selected information from Gerrard, Inc.'s financial activities in the most recent year was as follows:

- Net income was $330,000.
- The tax rate was 40%.
- 700,000 shares of common stock were outstanding on January 1.
- The average market price per share for the year was $6.
- Dividends were paid during the year.
- 2,000 shares of 8% $500 par value preferred shares, convertible into common shares at a rate of 200 common shares for each preferred share, were outstanding for the entire year.
- 200,000 shares of common stock were issued on March 1.

Gerrard, Inc.'s diluted earnings per share (diluted EPS) was *closest* to:

A) $0.197.

B) $0.261.

C) $0.289.

Explanation

To compute Gerrard's basic earnings per share (EPS) ((net income – preferred dividends) / weighted average common shares outstanding), the weighted average common shares outstanding must be computed. 700,000 shares were outstanding from January 1, and 200,000 shares were issued on March 1, so the weighted average is 700,000 + (200,000 × 10 / 12) = 866,667. Basic EPS was $330,000 − (2,000 × $500 × 0.08)) / 866,667 = $0.289.

If the convertible preferred shares were converted to common stock, 2,000 × 200 = 400,000 additional common shares would have been issued and dividends on the preferred stock would not have been paid. Diluted EPS was $330,000 / (866,667 + 400,000) = $0.261.

(Module 18.4, LOS 18.h)

Question #51 of 155

Question ID: 1457309

The following data pertains to the Sapphire Company:

- Net income equals $15,000.
- 5,000 shares of common stock issued on January 1st.
- 10% stock dividend issued on June 1st.
- 1,000 shares of common stock were repurchased on July 1st.
- 1,000 shares of 10%, $100 par preferred stock each convertible into 8 shares of common were outstanding the whole year.

What is the company's diluted earnings per share (EPS)?

A) $2.50.

B) $1.15.

C) $1.00.

Explanation

Number of average common shares:

1/1 5,500 shares issued (includes 10% stock dividend on 6/1) × 12 = 66,000

7/1 1,000 shares repurchased × 6 months = -6,000

= 60,000

60,000 shares / 12 months = 5,000 average shares

Preferred dividends = ($10)(1,000) = $10,000

Number of shares from the conversion of the preferred shares = (1,000 preferred shares)(8 × 1.1 shares of common/share of preferred) = 8,800 common

Diluted EPS = [$15,000(NI) – $10,000(pfd) + $10,000(pfd)] / (5,000 common shares + 8,800 shares from the conv. pfd.) = $15,000 / 13,800 shares = $1.09/share

This number needs to be compared to basic EPS to see if the preferred shares are antidilutive.

Basic EPS = [$15,000(NI) – $10,000(preferred dividends)] / 5,000 shares = $5,000 / 5,000 shares = $1/share

Since the EPS after the conversion of the preferred shares is greater than before the conversion the preferred shares are antidilutive and they should not be treated as common in computing diluted EPS. Therefore diluted EPS is the same as basic EPS or $1/share.

(Module 18.4, LOS 18.h)

Question #52 of 155

Question ID: 1457301

CXW, Inc. has issued 9,986 warrants, which were outstanding for the entire year, with an exercise price of $38. Each warrant is convertible into 1 share of common. The average market price of CXW's common stock for the year is $52.00 per share and its price at the end of the year is $45.00 per share. In the calculation of CXW's diluted earnings per share, how many new shares would theoretically need to be issued to facilitate warrant conversion?

A) 2,689.

B) 8,433.

C) 9,986.

Explanation

If the warrants were exercised, the firm would receive the exercise price for each warrant:

9,986 × $38 = $379,468

Using the treasury stock method, we assume the firm uses this cash to repurchase shares at the average price for the year:

$379,468 / $52 = 7,297 common shares

If these repurchased shares were used toward fulfilling the warrants, the firm would need to issue 9,986 – 7,297 = 2,689 new common shares to fulfill the rest of the warrants.

(Module 18.4, LOS 18.g)

Question #53 of 155

Question ID: 1457274

A firm had the following numbers of shares outstanding during the year:

Beginning of year	8,000,000 shares
Issued on April 1	750,000 shares
Paid stock dividend of 20% on July 1	
Issued on October 1	100,000 shares
Purchased Treasury stock November 1	1,000,000 shares
Split 2 for 1 on December 31	

Based on this information, what is the weighted number of shares outstanding for the year?

A) 42,444,444.

B) 20,783,333.

C) 20,266,667.

Explanation

Outstanding all year	8,000,000 × 1.2 × 2 × 1.0	19,200,000
Outstanding for 0.75 years	750,000 × 1.2 × 2 × 0.75	1,350,000
Outstanding for 0.25 years	100,000 × 2 × 0.25	50,000
Retired for 2 months	-1,000,000 × 2 × (2/12)	
Weighted average number of shares for year:		**20,266,667**

(Module 18.4, LOS 18.g)

Question #54 of 155

Question ID: 1457317

Assume that the exercise price of an option is $5, and the average market price of the stock is $8. Assuming 816 options are outstanding during the entire year, what is the number of shares to be added to the denominator of the diluted EPS?

A) 510.

B) 816.

C) 306.

Explanation

(816)(5) = $4,080. $4,080 / $8 = 510 shares. 816 − 510 = 306 new shares or [(8 − 5) / 8]816 = 306.

(Module 18.4, LOS 18.h)

Question #55 of 155

Question ID: 1457277

Which of the following debt securities issued by a company would give it a complex capital structure?

A) Floating rate notes.

B) Asset-backed securities.

C) Convertible bonds.

Explanation

A complex capital structure means a firm has securities outstanding that can be converted to common shares, and therefore have the potential to dilute a firm's earnings per share. For example, convertible bonds, convertible preferred stock, options, and warrants have the potential to dilute earnings per share upon conversion or exercise.

(Module 18.4, LOS 18.g)

Question #56 of 155

Question ID: 1457329

Selected information from Caledonia, Inc.'s financial activities in the year 20X6 is as follows:

- Net income = $460,000.
- 2,300,000 shares of common stock were outstanding on January 1.
- The average market price per share was $2 and the year-end stock price was $1.50.
- 1,000 shares of 8%, $1,000 par value preferred shares were outstanding on January 1. Preferred dividends were paid in 20X6.
- 10,000 warrants, each of which allows the holder to purchase 100 shares of common stock at an exercise price of $1.50 per common share, were outstanding the entire year.

Caledonia's diluted earnings per share for 20X6 are *closest* to:

A) $0.180.

B) $0.15.

C) $0.165.

Explanation

> Caledonia's basic EPS = (net income − preferred stock dividends) / (weighted average common shares outstanding)
>
> = [$460,000 − ($1,000 × 1,000 × 0.08)] / 2,300,000 = $0.17.

Using the treasury stock method, if the warrants were exercised, cash inflow would be 10,000 × 100 × $1.50 = $1,500,000. The number of Caledonia shares that could be purchased with the inflow, using the average share price, is $1,500,000 / $2 = 750,000. The net increase in common shares outstanding would have been 1,000,000 − 750,000 = 250,000.

Diluted EPS = $380,000 / (2,300,000 + 250,000) = $0.15.

(Module 18.4, LOS 18.h)

Question #57 of 155

Question ID: 1457222

Do gains and losses, as well as expenses appear on the income statement?

A) Both appear on the income statement. ✓

B) Only expenses appear on the income statement. ✗

C) Only gains and losses appear on the income statement. ✗

Explanation

Gains and losses result from, transactions that are not a part of the firm's normal business operations. Expenses are amounts that are incurred to generate revenue; thus, expenses result from the firm's ongoing operations. Both are included on the income statement.

(Module 18.1, LOS 18.a)

Question #58 of 155

Question ID: 1457283

A complex capital structure, for purposes of determining disclosure of diluted earnings per share, is distinguished from a simple capital structure by the company having outstanding:

A) debt securities or convertible securities. ✗

B) preferred stock, warrants, or options. ✗

C) warrants, convertible securities, or options. ✓

Explanation

A complex structure contains potentially dilutive securities. These include any securities that can potentially be converted into common shares, such as options, warrants, convertible preferred stock, or convertible bonds. Simple capital structures contain no potentially dilutive securities but may include non-convertible debt securities or non-convertible preferred stock.

(Module 18.4, LOS 18.g)

Question #59 of 155

Question ID: 1457332

The Allen Corporation had 100,000 shares of common stock outstanding at the beginning of the year. Allen issued 30,000 shares of common May 1. On July 1, the company issued a 10% stock dividend. On September 1, Allen issued 1,000, 10% bonds convertible into 21 shares of stock each. What is the weighted average number of shares to be used in computing basic and diluted earnings per share (EPS), assuming the convertible bonds are dilutive?

	Basic Shares	Diluted Shares	
A)	132,000	139,000	✓
B)	130,000	132,000	✗
C)	132,000	146,000	✗

Explanation

Calculating Basic Shares:

Jan 1 100,000 shares outstanding

May 1 30,000 shares issued

July 1 10% stock dividend issued

The 10% stock dividend is retroactive therefore:

110,000 shares × 12 months = 1,320,000

33,000 shares × 8 months = 264,000

Total share-month = 1,584,000

Average shares = (1,584,000 / 12) = 132,000

Calculating diluted shares:

(1,000 bonds) × (21 shares each) × (4 months) = 84,000 total share-month

84,000 / 12 = 7,000 Average shares

Total diluted shares = 7,000 (from convertible bonds) + 132,000 (from stock) = 139,000

(Module 18.4, LOS 18.h)

Question #60 of 155

Question ID: 1457357

An analyst compiled the following information from Hampshire, Inc.'s financial activities in the most recent year:

- Net income was $2,800,000.
- 100,000 shares of common stock were outstanding on January 1.
- The average market price per share for the year was $250.
- 10,000 shares of 6%, $1,000 par value preferred shares were outstanding the entire year.
- 10,000 warrants, which allow the holder to purchase 10 shares of common stock for each warrant held at a price of $150 per common share, were outstanding the entire year.
- 30,000 shares of common stock were issued on September 1.

Hampshire, Inc.'s diluted earnings per share are *closest* to:

A) $18.38.

B) $14.67.

C) $20.00.

Explanation

To compute Hampshire's basic EPS ((net income – preferred dividends) / weighted average common shares outstanding), the weighted average common shares must be computed. 100,000 shares were outstanding from January 1, and 30,000 shares were issued on September 1, so the weighted average is 100,000 + (30,000 × 4 / 12) = 110,000. Basic EPS is ($2,800,000 – (10,000 × $1,000 × 0.06)) / 110,000 = $20.00.

If the warrants were exercised, cash inflow would be 10,000 × $150 × 10 = $15,000,000 for 10 × 10,000 = 100,000 shares. Using the treasury stock method, the number of Hampshire shares that can be purchased with the cash inflow (cash inflow / average share price) is $15,000,000 / $250 = 60,000. The number of shares that would be created is 100,000 – 60,000 = 40,000. Diluted EPS is $2,200,000 / (110,000 + 40,000) = $14.67.

(Module 18.4, LOS 18.h)

Question #61 of 155

Question ID: 1457321

A 12 percent $100,000 convertible bond was issued on October 1, 2004. It is dilutive and can be converted into 18,000 shares. The effective income tax rate for the year was 40%. What adjustments should be made to calculate diluted earnings per share?

Interest added to the numerator	Shares added to the denominator

A)	$1,800	4,500	✓
B)	$3,000	4,500	✗
C)	$3,000	18,000	✗

Explanation

The interest expense for three months net of tax is added to the numerator (12% × $100,000 × 3/12 × 60 %) = $1,800. The number of shares added to the denominator are 4,500. (18,000 × 3 / 12).

(Module 18.4, LOS 18.h)

Question #62 of 155

Question ID: 1457328

Young Distributors, Inc. issued convertible bonds two years ago, and those bonds are the only potentially dilutive security Young has issued. In 20X5, Young's basic earnings per share (EPS) and diluted EPS were identical, but in 20X4 they were different. Which of the following factors is *least likely* to explain the difference between basic and diluted EPS? The:

A) average market price of Young common stock increased in 20X5. ✓

B) bonds were antidilutive in 20X5 but not in 20X4. ✗

C) bonds were redeemed by Young Distributors at the beginning of 20X5. ✗

Explanation

Average stock price is not a factor in determining whether convertible bonds are dilutive or antidilutive.

If Young redeemed the bonds, they would have no potentially dilutive securities outstanding in 20X5 and diluted EPS, if the company reported it, would equal basic EPS. Basic and diluted EPS would also be equal in 20X5 if the bonds were antidilutive in that year.

(Module 18.4, LOS 18.h)

Question #63 of 155

Question ID: 1457316

The Widget Company had net income of $1 million for the period. There were 1 million shares of widget common stock outstanding for the entire period. If there are 100,000 options outstanding with an exercise price of $40, what is the diluted earnings per share for Widget common stock if the average price per share over the period was $50?

A) $0.98.

B) $0.99.

C) $1.00.

Explanation

Use the Treasury stock method

Proceeds = 100,000 ($40) = $4,000,000

Shares assumed purchased with proceeds= $4,000,000/$50 = 80,000 shares

Potential dilution = 100,000 – 80,000 = 20,000 shares

Basic EPS = $1/share

Diluted EPS = $1,000,000 / 1,020,000 = $0.98/share

(Module 18.4, LOS 18.h)

Question #64 of 155

Question ID: 1457367

A company reports a gain of €100,000 on the sale of an asset and a loss of €100,000 due to foreign currency translation adjustment. Which of these items will be included in the company's comprehensive income?

A) Neither of these items is included in comprehensive income.

B) Only one of these items is included in comprehensive income.

C) Both of these items are included in comprehensive income.

Explanation

Both items are included in comprehensive income. Comprehensive income includes all items that affect owners' equity except transactions with the company's owners. Any items that are included in net income are also included in comprehensive income. The gain on sale is reported in net income. The foreign currency translation loss is taken directly to owners' equity (i.e., not reported in the income statement).

(Module 18.5, LOS 18.k)

Question #65 of 155

Question ID: 1482629

For the year ended December 31, 20X7, Milan Company reported the following financial information:

Gross profit from sales	$600,000
Operating expenses	100,000
Unrealized loss from foreign currency translation	30,000
Dividends received from available-for-sale securities	15,000
Remeasurement of net pension liability	45,000
Interest expense	25,000
Acquired treasury stock for $25,000 more than original book value	75,000
Unrealized gain from available-for-sale-securities	20,000

Ignoring taxes, Milan's comprehensive income for 20X7 is:

A) $435,000.

B) $44,000.

C) $2,000.

Explanation

Net income is equal to $490,000 ($600,000 gross profit – $100,000 operating expenses + $15,000 dividends received – $25,000 interest expense). Comprehensive income includes all transactions that affect stockholders' equity *except* transactions with shareholders. Thus, comprehensive income is equal to $435,000 ($490,000 net income – $30,000 unrealized loss from foreign currency translation – $45,000 remeasurement of net pension liability + $20,000 unrealized gain on available-for-sale securities). The treasury stock purchase is a transaction with shareholders and is not included in either comprehensive income or net income.

(Module 18.5, LOS 18.k)

Question #66 of 155

Question ID: 1457368

Barracuda Corporation, a U.S. corporation, owns a subsidiary located in Germany. The German subsidiary's financial statements are maintained in euros. If the euro recently appreciated relative to the U.S. dollar, how would the unrealized translation gain affect Barracuda's retained earnings and total stockholders' equity?

	Retained earnings	Total stockholders' equity	
A)	Increase	Increase	✗
B)	No effect	Increase	✓
C)	No effect	No effect	✗

Explanation

Unrealized foreign currency translation gains and losses are not reported in the income statement; thus, retained earnings are unaffected. However, unrealized foreign currency gains and losses are included in comprehensive income. Comprehensive income includes all changes in equity except those that result from transactions with shareholders. So, the translation gain increases stockholders' equity by increasing comprehensive income.

(Module 18.5, LOS 18.k)

Question #67 of 155

Question ID: 1457263

Connecticut, Inc.'s stock transactions during the year 20X5 were as follows:

- January 1: 360,000 common shares outstanding.
- April 1: 1 for 3 reverse stock split.
- July 1: 60,000 common shares issued.

When computing for earnings per share (EPS) computation purposes, what is Connecticut's weighted average number of shares outstanding during 20X5?

A) 140,000. ✗

B) 210,000. ✗

C) 150,000. ✓

Explanation

Connecticut's January 1 balance of common shares outstanding is adjusted retroactively for the 1 for 3 reverse stock split, meaning there are (360,000 / 3) = 120,000 "new" shares treated as if they had been outstanding since January 1. The weighted average of the shares issued in July, (60,000 × 6 / 12) = 30,000 is added to that figure, for a total of 150,000.

(Module 18.4, LOS 18.g)

Question #68 of 155

Question ID: 1457314

The Fischer Company had net income of $1,500,000. Fischer paid preferred dividends of $5 on each of the 100,000 preferred shares. There are 1 million Fischer common shares outstanding. In addition to the common and preferred stock, Fischer has $25 million of 4% bonds outstanding. The face value of each bond is $1,000. Each bond is convertible into 40 common shares. If Fischer's tax rate is 40%, determine its basic and diluted earnings per share (EPS)?

	Basic EPS	Diluted EPS	
A)	$1.00	$0.80	✓
B)	$1.50	$1.25	✗
C)	$1.00	$1.25	✗

Explanation

$$\text{Basic EPS} = \frac{(\$1{,}500{,}000 - \$500{,}000)}{1{,}000{,}000} = \$1.00$$

$$\text{Diluted EPS} = \frac{(\$1{,}500{,}000 - \$500{,}000) + \$1{,}000{,}000(1 - 0.4)}{1{,}000{,}000 + 1{,}000{,}000} = \frac{\$1{,}600{,}000}{2{,}000{,}000} = \$0.80$$

(Module 18.4, LOS 18.h)

Question #69 of 155

Question ID: 1462809

During 20X3, Rory, Inc., reported net income of $15,000 and had 2,000 shares of common stock outstanding for the entire year. Rory also had 2,000 shares of 10%, $50 par value preferred stock outstanding during 20X3. During 20X1, Rory issued 100, $1,000 par, 6% bonds for $100,000. Each of the bonds is convertible to 50 shares of common stock. Rory's tax rate is 40%. Assuming these bonds are dilutive, 20X3 diluted EPS for Rory is *closest* to:

A) $2.50.

B) $0.71.

C) $1.23.

Explanation

Diluted EPS = [NI − preferred dividends + convertible interest (1 − t)] / [weighted average shares + convertible debt shares]

100(1,000)(6%)(1 − 0.4) = $3,600; convertible debt shares = 50(100) = 5,000

$$\frac{\$15{,}000-\$10{,}000+\$3{,}600}{2{,}000+5{,}000}=\$1.23$$

(Module 18.4, LOS 18.g)

Question #70 of 155

Question ID: 1457251

Suppose that JPK, Inc., paid dividends of $80,000 to its preferred shareholders and $40,000 to its common shareholders during 2004. The company had 20,000 shares of common stock issued and outstanding on January 1, 2004, issued 7,000 more shares on June 1, 2004, and paid a 10% stock dividend on August 1, 2004. Assuming that JPK had $150,000 in net income, what is the firm's basic earnings per share (EPS) for 2004?

A) $2.64.

B) $2.91.

C) $2.71.

Explanation

1/1/00 22,000 shares (adjusted for 10% stock dividend) × 12 months = 264,000

6/1/00 7,700 shares (adjusted for 10% stock dividend) × 7 months = 53,900

Total share month = 317,900

Average shares = 317,900 / 12 = 26,492

Basic EPS = ($150,000 − $80,000) / 26,492 = 2.64

(Module 18.4, LOS 18.g)

Question #71 of 155

Question ID: 1457255

At the beginning of 2004, the Alaska Corporation had 2 million shares of common stock outstanding and no preferred stock. At the end of August, 2004, Alaska issued 600,000 new shares of common stock. If Alaska reported net income equal to $8.8 million, what was the firm's earnings per share for 2004?

A) $3.38.

B) $3.67.

C) $4.00.

Explanation

EPS = earnings available to common shareholders divided by the weighted average number of common shares outstanding. With no preferred shareholders, all of net income is available to the common shareholders. The weighted average number of shares outstanding equals the original 2 million shares plus 4/12 of the additional 600,000 shares. The 4/12 weight is used because the new shares were only outstanding 4 months of the year. Thus, EPS = $8.8 million / [2 million + (4/12)(600,000)] = 8.8/2.2 = $4.00.

(Module 18.4, LOS 18.g)

Question #72 of 155

Question ID: 1457356

Selected information from Feder Corp.'s financial activities for the year is as follows:

- Net income was $7,650,000.
- 1,100,000 shares of common stock were outstanding on January 1.
- The average market price per share was $62.
- Dividends were paid during the year.
- The tax rate was 40%.
- 10,000 shares of 6% $1,000 par value preferred shares convertible into common shares at a rate of 20 common shares for each preferred share were outstanding for the entire year.
- 70,000 options, which allow the holder to purchase 10 shares of common stock at an exercise price of $50 per common share, were outstanding the entire year.

Feder Corp.'s diluted earnings per share (EPS) was *closest* to:

A) $4.91.

B) $5.32.

C) $5.87.

Explanation

Feder's basic earnings per share ((net income – preferred dividends) / weighted average shares outstanding) was (($7,650,000 – ($1,000 × 10,000 × 0.06)) / 1,100,000 =) $6.41.

If the convertible preferred stock was converted to common stock at January 1, (10,000 × 20 =) 200,000 additional common shares would have been issued, dividends on the preferred stock would not have been paid, and Diluted EPS would have been ($7,650,000 / (1,100,000 + 200,000) = $5.88. Because $5.88 is less than basic EPS of $6.41, the preferred shares are dilutive.

Using the treasury stock method, if the options were exercised cash inflow would be (70,000 × 10 × $50 =) $35,000,000. The number of Feder shares that can be purchased with the inflow (cash inflow divided by the average share price) is ($35,000,000 / $62 =) 564,516.

The number of shares that would have been created is (700,000 – 564,516 =) 135,484. Diluted EPS was [($7,650,000 – ($1,000 × 10,000 × 0.06)] / (1,100,000 + 135,484) =) $5.71. Because this is less than the EPS of $6.41, the options are dilutive.

Combining the calculations, Diluted EPS was (($7,650,000) / (1,100,000 + 200,000 + 135,484) = $5.32.

(Module 18.4, LOS 18.h)

Question #73 of 155

Question ID: 1462813

An analyst gathered the following data about a company:

- The company had 500,000 shares of common stock outstanding for the entire year.
- The company's beginning stock price was $40, its ending price was $60, and its average price over the year was $50.
- The company has 120,000 warrants outstanding for the entire year.
- Each warrant allows the holder to buy one share of common stock at $45 per share.

How many shares of common stock should the company use in computing its diluted earnings per share?

A) 500,000.

B) 488,000.

C) 512,000.

Explanation

Dilution occurs since the exercise price for the warrants ($45) is less than the average market price for the shares ($50). The incremental number of shares outstanding is found from:

$$\left(\frac{\text{market price}-\text{exercise price}}{\text{market price}}\right) \times \#\text{ warrants} = \left(\frac{50-45}{50}\right) \times 120{,}000 = 12{,}000$$

Number of shares to use in diluted EPS calculation = 500,000 + 12,000 = 512,000. (Module 18.4, LOS 18.h)

Question #74 of 155

Question ID: 1457270

Consider the following information on the past year's operating performance and current capital structure for the following two companies:

Supple Moves	*Perfect Collection*
Paid no dividends	Paid common & pref. div.
Ave. Stock Price of $42.00	Ave. Stock Price of $22.00
Positive net income	Positive net income
110,000 warrants with an exercise price of $50.00	Convertible debt with an 8.0% coupon, conversion ratio at 10.0.
	150,000 options outstanding with an exercise price of $19.50

Based on the information above, which of the companies has a complex capital structure?

A) Supple Moves only.

B) Perfect Collection only.

C) Supple Moves and Perfect Collection.

Explanation

A complex capital structure is one that has *potentially* dilutive elements. Here, Supple Moves and Perfect Collection both meet this criteria. (The warrants for Supple Moves will be dilutive if the average stock prices were over $50.00.)

(Module 18.4, LOS 18.g)

Question #75 of 155

Question ID: 1457243

Which of the following items for a financial services company is *least likely* to be considered an operating item on the income statement?

A) Financing expenses.

B) Income tax expense.

C) Interest income.

Explanation

For a financial services company, interest income, interest expense, and financing expenses are likely considered operating activities. For both financial and nonfinancial companies, income tax expense is a non-operating item that is reported within "income from continuing operations" as opposed to "operating profit" as with the other answer choices. Therefore, of the three choices, income tax expense is least likely to be considered an operating item.

(Module 18.3, LOS 18.f)

Question #76 of 155

Question ID: 1457318

An analyst has gathered the following information about Zany Corp.

- Net income of $200,000 for the year ended December 31, 2004.
- During 2004, 50,000 common shares were outstanding.
- Zany has 10,000 shares of 7%, $50 par convertible preferred stock outstanding, each convertible into two shares of common.
- 5,000 warrants are outstanding with an exercise price of $24. Each warrant is convertible into one common share.
- The average market price per common share during 2004 was $20.

Calculate Zany's basic and diluted earnings per share (EPS) for 2004.

	Basic EPS	Diluted EPS
A)	$4.00	$2.86
B)	$3.30	$2.00
C)	$3.30	$2.86

Explanation

Basic EPS = (net income − preferred dividends) / number of common shares = (200,000 − 35,000) / 50,000 = $3.30 per share

The preferred shares are converted into 20,000 common shares, the firm does not pay preferred dividends. Diluted EPS = 200,000 / (50,000 + 20,000) = $2.86 per share. The warrants are out of the money at a stock price of $20.

(Module 18.4, LOS 18.h)

Question #77 of 155

Question ID: 1457281

Jersey, Inc.'s financial information included the following for its year ended December 31:

- 160,000 shares of common stock were outstanding for the entire year.
- 18,000 shares of 10%, $100 par value cumulative preferred stock were outstanding for the entire year.
- Common stock dividends paid during the current year were $240,000.
- All preferred stock dividends were paid for the current year.
- Net income was $720,000.

Basic earnings per share for Jersey, Inc. for the year ended December 31 are *closest to:*

A) $3.38. ✓

B) $4.50. ✗

C) $2.81. ✗

Explanation

Jersey, Inc.'s basic EPS = (net income – preferred dividends) / (weighted average number of common shares outstanding) was ($720,000 - $180,000)/160,000 = $3.38.

(Module 18.4, LOS 18.g)

Question #78 of 155

Question ID: 1457373

According to the Financial Accounting Standards Board, what is the appropriate balance sheet treatment for available-for-sale securities and where are the unrealized gains and losses reported?

Balance sheet	Unrealized gains and losses

A)	Amortized cost	Other comprehensive income	✗
B)	Fair value	Net income	✗
C)	Fair value	Other comprehensive income	✓

Explanation

Available-for-sale securities are reported on the balance sheet at fair value. The unrealized gains and losses bypass the income statement and are reported as a component of stockholders' equity as a part of other comprehensive income.

(Module 18.5, LOS 18.l)

Question #79 of 155

Question ID: 1457272

Robinson Company had 1 million shares outstanding at the beginning of the year. On April 1, Robinson issued an additional 300,000 shares. On July 1, Robinson issued 200,000 more shares. What is Robinson's weighted average number of shares outstanding for the calculation of earnings per share?

A) 1,500,000 shares. ✗

B) 1,325,000 shares. ✓

C) 1,200,000 shares. ✗

Explanation

The 300,000 shares issued on April 1 were outstanding for 8 months, or 8 / 12 = 75% of the year. The 200,000 shares issued on July 1 were outstanding for 6 months, or 6 / 12 = 50% of the year. Weighted average shares = 1,000,000 + (0.75) 300,000 + (0.5) 200,000 = 1,325,000 shares

(Module 18.4, LOS 18.g)

Question #80 of 155

Question ID: 1457291

Zichron, Inc., had the following equity accounts on December 31:

- Common stock: 20,000 shares.
- Preferred stock A: 10,000 shares convertible into common on a 2 for 1 basis, dividend of $40,000 was declared during the year.
- Preferred stock B: 10,000 shares, convertible to common on a 4 for 1 basis, dividend of $5,000 was declared during the year.
- The company reported net income of $120,000 and paid a $20,000 dividend to its common shareholders.

Basic earnings per share for the year are:

A) $3.75. ✓

B) $2.00. ✗

C) $2.75. ✗

Explanation

Basic EPS = ($120,000 − 40,000 − 5,000) / 20,000 shares = $3.75.

(Module 18.4, LOS 18.g)

Question #81 of 155

Question ID: 1462806

Gus Davy, CFA, is reviewing an industry that has been experiencing rising prices as well as unit volume growth. Davy's investment criteria include selecting companies generating the highest profit margins. If Davy does not adjust companies' financial statements for their inventory cost assumptions, he is *most likely* to select companies that use:

A) LIFO. ✗

B) FIFO. ✓

C) weighted average cost. ✗

Explanation

The FIFO method recognizes the oldest costs in the cost of goods sold. With rising prices, COGS will be lower and net income will be higher using FIFO as compared to the LIFO or average cost methods. Higher net income relative to sales (which are not affected by the inventory cost method) means higher profit margins. (Module 18.3, LOS 18.d)

Question #82 of 155

Question ID: 1457324

Rushford Corp.'s net income is $16,500,000 with 300,000 shares outstanding. The tax rate is 40%. The average share price for the year was $372. Rushford has 50,000, 9%, $1,000 par value convertible bonds outstanding. Each bond is convertible into two shares of common stock.

Rushford Corp.'s basic and diluted earnings per share (EPS) are *closest* to:

	Basic EPS	Diluted EPS	
A)	$55.00	$51.56	✗
B)	$65.63	$48.00	✗
C)	$55.00	$48.00	✓

Explanation

Rushford's basic EPS (net income / weighted average common shares outstanding) is $16,500,000 / 300,000 = $55.00. Diluted EPS is calculated under the assumption that the convertible bonds were converted into common stock, the bond interest net of tax is restored to net income, and the additional common shares are added to the denominator of the equation. Rushford's diluted EPS is [$16,500,000 + (50,000 × $1,000 × 0.09)(1 - .40)] / (300,000 + (50,000 × 2) = $48.00.

(Module 18.4, LOS 18.h)

Question #83 of 155

Question ID: 1457320

On December 31, 2004, JME Corporation had 350,000 shares of common stock outstanding. On September 1, 2005, an additional 150,000 shares of common stock were issued. In addition, JME had $10 million of 8% convertible bonds outstanding at December 31, 2004, which are convertible into 200,000 shares of common stock. Net income for 2005 was $3 million. Assuming an income tax rate of 40%, what amount should be reported as the diluted earnings per share for 2005?

A) $6.00. ✗

B) $5.80. ✓

C) $5.00. ✗

Explanation

If bonds are converted, then net income will increase by 480,000 [10 million × 0.08 × (1 − 0.4)] and shares outstanding will increase by 200,000.

numerator = 3,000,000 + 480,000 = 3,480,000

denominator = 350,000 + (150,000 × 4/12) + 200,000 = 600,000

diluted EPS = 3,480,000 / 600,000 = 5.80

(Module 18.4, LOS 18.h)

Question #84 of 155

Question ID: 1457271

At the beginning of 2004, Osami Corporation had 1.4 million shares of common stock outstanding and no preferred stock. At the end of August 2004, Osami issued 1.2 million new shares of common stock. If Osami reported net income equal to $7.2 million, what were its earnings per share (EPS) for 2004?

A) $2.77.

B) $3.33.

C) $4.00.

Explanation

The new shares were only outstanding 4 months of the year. Thus, the weighted average number of shares outstanding is [1.4 + (4/12)(1.2)] million = 1.8 million shares. So basic EPS = $7.2 million / 1.8 million = $4.00.

(Module 18.4, LOS 18.g)

Question #85 of 155

Question ID: 1457266

Ajax Company has a simple capital structure. Which of the following will NOT be found on its balance sheet?

A) 6%, $50 par value callable bond.

B) 10%, secured mortgage bond denominated in Swiss francs.

C) 3%, $100 par value convertible bond.

Explanation

If convertible bonds exist, the firm has a complex capital structure.

(Module 18.4, LOS 18.g)

Question #86 of 155

Question ID: 1462811

Which of the following statements about the calculation of earnings per share (EPS) is *least accurate*?

A) Reacquired shares are excluded from the computation from the date of reacquisition. ✗

B) Shares issued after a stock split must be adjusted for the split. ✓

C) Options outstanding may have no effect on diluted EPS. ✗

Explanation

Shares issued post-split need not be adjusted for the split as they are already "new" shares. Options with an exercise price greater than the average share price do not affect diluted EPS. (Module 18.4, LOS 18.g)

Question #87 of 155

Question ID: 1457246

The First National Bank is a commercial bank that specializes in consumer financing, particularly automobile loans. The majority of the loans are funded from customer deposits. In addition, the bank purchases various investment securities with available cash. The investments are debt securities and have an average maturity date of less than 30 days. Should First National Bank report the interest received from the consumer loans and the interest received from the investment securities as an operating or as a nonoperating component in its year-end income statement?

	Consumer loans	Investment securities	
A)	Nonoperating	Operating	✗
B)	Operating	Operating	✓
C)	Operating	Nonoperating	✗

Explanation

Interest received from customers and interest received from investments are a part of normal operations of a financial institution. Thus, the First National Bank will report the interest income from both sources as components of operating income.

(Module 18.3, LOS 18.f)

Question #88 of 155

Question ID: 1457325

Selected information from Jupiter Corp.'s financial activities in the year 20X5 is as follows:

- Net income is $18,300,000.
- 115,000 shares of common stock were outstanding on January 1.
- The average market price per share was $150 in 20X5.
- 200 warrants, which each allow the holder to purchase 100 shares of common stock at an exercise price of $100 per common share, were outstanding the entire year.
- 60,000 shares of common stock were issued on April 1.
- 45,000 shares of common stock were purchased by the company as treasury stock on October 1.

Jupiter Corp.'s diluted earnings per share for 20X5 are *closest* to:

A) $117.75. ✓

B) $123.02. ✗

C) $159.13. ✗

Explanation

To compute Jupiter's basic earnings per share (EPS) use the formula: (net income − preferred dividends) / weighted average common shares outstanding. Weighted average common shares outstanding = [(115,000 × 12) + (60,000 × 9) – (45,000 × 3)] / 12 = 148,750. Basic EPS = $18,300,000 / 148,750 = $123.02.

Using the treasury stock method, if the warrants were exercised cash inflow would be 200 × $100 × 100 = $2,000,000. The number of Jupiter shares that can be purchased with this cash at the average share price is $2,000,000 / $150 = 13,333. The net number of shares that would have been created is 20,000 − 13,333 = 6,667. Diluted EPS = $18,300,000 / (148,750 + 6,667) = $117.75. Since diluted EPS is less than basic EPS, the warrants are dilutive.

(Module 18.4, LOS 18.h)

Question #89 of 155

Question ID: 1457223

Would an increase in the cost of raw materials used in the production of inventory and would an increase in marketing expenses result in lower gross profit?

	Increase in raw materials cost	Increase in marketing expense	
A)	No	Yes	✗
B)	Yes	No	✓
C)	Yes	Yes	✗

Explanation

Gross profit is equal to sales minus cost of goods sold. Cost of goods sold includes the direct costs of producing a product or service such as raw materials, direct labor, and overhead (fixed costs). Thus, an increase in raw materials costs will result in higher cost of goods sold and lower gross profit. Marketing expenses are considered operating expenses (SG&A), not in cost of goods sold.

(Module 18.1, LOS 18.a)

Question #90 of 155

Question ID: 1457353

Examples of potentially dilutive securities *least likely* include:

A) stock options. ✗

B) premium bonds. ✓

C) convertible preferred stock. ✗

Explanation

Whether a bond is issued or valued at a premium or discount is not relevant to whether the bond is potentially dilutive to earnings per share. Bonds and preferred stock are only potentially dilutive if they are convertible to common shares. Stock options and warrants are potentially dilutive because they will increase common shares outstanding if they are exercised.

(Module 18.4, LOS 18.h)

Question #91 of 155

Question ID: 1457322

A company has convertible preferred stock outstanding. In the computation of diluted earnings per share, common shares issued when convertible preferred stock is converted are added to the denominator of the basic EPS equation, and the numerator is:

A) adjusted by adding back convertible preferred stock dividends. ✓

B) adjusted by adding back non-convertible preferred stock dividends. ✗

C) not adjusted. ✗

Explanation

If convertible preferred stock is dilutive, the preferred dividends that would not have been paid if the preferred stock is converted must be added back to the numerator. Note that any nonconvertible preferred stock dividends are still subtracted from net income in the numerator.

(Module 18.4, LOS 18.h)

Question #92 of 155

Question ID: 1457330

Kendall Company's net income for 20X4 is $830,000 with 200,000 shares outstanding. Kendall has 1,000 6% convertible bonds (each bond $1,000 face value and convertible into 20 common shares) outstanding for the entire year. Kendall's tax rate is 40%. What is Kendall Company's diluted earnings per share for 20X4?

A) $3.77. ✗

B) $3.94. ✓

C) $4.15. ✗

Explanation

Kendall's basic EPS is $830,000 / 200,000 = $4.15. To compute diluted EPS, bond interest paid net of taxes is added to net income, and the number of shares that would be issued in the conversion is added to the denominator. Kendall's diluted EPS = [$830,000 + (1,000 × $1,000 × 0.06) × (1 – 0.4)] / (200,000 + 20,000) = $3.94. Since diluted EPS is less than basic EPS, we know that the bonds are dilutive and should be considered in calculating diluted EPS.

(Module 18.4, LOS 18.h)

Question #93 of 155

Question ID: 1457282

Bluff, Inc.'s stock transactions during the year were as follows:

January 1	90,000 common shares outstanding.
April 1	20% stock dividend is declared and issued.
October 1	10,000 shares are reacquired as treasury stock.

What is Bluff's weighted average number of shares outstanding during the year?

A) 98,000.

B) 101,000.

C) 105,500.

Explanation

Initial shares: 90,000 × 1.20 =	108,000
– Reacquired treasury shares: 10,000 × 3/12 =	–2,500
	105,500

(Module 18.4, LOS 18.g)

Question #94 of 155

Question ID: 1457247

A company reports the following unusual events:

- Loss on discontinued operations.
- Restructuring and severance costs applicable to asset sales.
- Plant shutdown costs.

Which of these items would *most likely* be considered nonrecurring and included in operating income?

A) Restructuring and severance costs applicable to asset sales and plant shutdown costs.

B) Loss on discontinued operations and restructuring and severance costs applicable to asset sales.

C) Loss on discontinued operations and plant shutdown costs.

Explanation

Restructuring and plant shutdown costs are considered part of a company's normal operations. Gains and losses related to discontinued operations are reported separately in the income statement because these activities are no longer included as part of the company's continuing operations.

(Module 18.3, LOS 18.f)

Question #95 of 155

Question ID: 1457231

JME Construction signs a contract in the amount of $10 million with the following data available:

Costs incurred in Year 1	$2,200,000
Billings in Year 1	$2,000,000
Cash collected in Year 1	$1,750,000
Total cost of project	$8,800,000

How much revenue should JME recognize for Year 1?

A) $2,500,000.

B) 1,750,000.

C) 2,270,000.

Explanation

Percentage of completion = 25%(2.2 / 8.8)

Revenue to be recognized in Year 1 = 0.25 × 10 million = 2.5 million

(Module 18.2, LOS 18.c)

Question #96 of 155

Question ID: 1457232

The first-in-first-out (FIFO) expense recognition method for inventories *best* describes the physical flow of goods if customers typically purchase units:

A) from the top of a stack.

B) in the same order the units are produced.

C) selectively from among all units for sale.

Explanation

The FIFO cost flow method best approximates the physical flow of goods if customers typically purchase units in the order the units are produced, such as goods with a limited shelf life. Last-in-first-out (LIFO) best approximates the flow of goods if customers purchase units from the top of a stack, as with raw materials such as coal or gravel. If customers choose individual units selectively from among all the units for sale, the flow of goods may be unclear and the average cost method may describe it best.

(Module 18.3, LOS 18.d)

Question #97 of 155

Question ID: 1457229

CPP Corporation has a contract to build a custom test chamber for a client for $100,000. CPP Corporation uses the percentage-of-completion method for accounting and estimates the total costs for the project to be equal to $80,000. CPP Corporation has promised to complete the project within three years. At year-end the customer has paid $60,000, equaling the total amount billed for the year, and total costs incurred to date are $40,000. On the income statement, net income for the year-end will be:

A) $10,000.00. ✓

B) $20,000.00. ✗

C) -$10,000.00. ✗

Explanation

Under the percentage-of-completion method, one-half of the total revenue is recognized because one-half of the costs have been incurred ($40,000 / $80,000). Therefore, revenue will be equal to $50,000, expenses are $40,000, and net income will be $10,000.

(Module 18.2, LOS 18.c)

Question #98 of 155

Question ID: 1457331

Quad Associates, Inc.'s net income for 2005 was $892,000 with 400,000 shares outstanding. The tax rate was 40 percent. Quad had 2,000 six percent $1,000 par value convertible bonds that were issued in 2004. Each bond was convertible into 40 shares of common stock. Quad, Inc.'s diluted earnings per share (Diluted EPS) for 2005 was *closest* to:

A) $2.23. ✗

B) $2.01.

C) $2.41.

Explanation

Quad's basic EPS (net income / weighted average common shares outstanding) was $892,000 / 400,000 = $2.23.

Diluted EPS is calculated under the assumption that the convertible bonds are converted into common stock, the bond interest net of tax is restored to net income, and the additional common shares are added to the denominator of the equation. Quad's diluted EPS was [$892,000 + (2,000 × $1,000 × 0.06)(1 − 0.40)] / [400,000 + (2,000 × 40)] = $2.01. Since diluted EPS is less than basic EPS, we know that the bonds are dilutive and should be considered in calculating diluted EPS.

(Module 18.4, LOS 18.h)

Question #99 of 155

Question ID: 1457267

A simple capital structure is *least likely* to include:

A) callable preferred stock.

B) treasury stock.

C) convertible bonds.

Explanation

Simple capital structures do not include any potentially dilutive securities (a security that could decrease earnings per share if exercised). Convertible bonds are potentially dilutive.

(Module 18.4, LOS 18.g)

Question #100 of 155

Question ID: 1457334

An analyst has gathered the following information about Barnstabur, Inc., for the year:

- Reported net income of $30,000.
- 5,000 shares of common stock and 2,000 shares of 8%, $90 par preferred stock outstanding during the whole year.
- Barnstabur, has $60,000 of 6.0% convertible bonds outstanding, with each of the 60 bonds convertible into 110 shares of Barnstabur common stock.

If Barnstabur's effective tax rate is 40%, what will Barnstabur report for diluted earnings per share (EPS)?

A) $1.66.

B) $1.53.

C) $2.36.

Explanation

Diluted EPS = adjusted earnings after conversion (EAC) / weighted average plus potential common shares outstanding.

Step 1: *Calculate Adjusted EAC*

adjusted EAC:		net income - preferred dividends
	+	after-tax interest on convertible debt
	=	adjusted earnings available for common shares

preferred dividends = (0.08)(90)(2,000) = 14,400

convertible debt interest = (60,000)(0.06)(1 – 0.40) = 2,160

adjusted EAC = (30,000 – 14,400 + 2,160) = **$17,760**

Step 2: *Calculate Weighted average plus potential common shares outstanding.*

weighted average common shares		=	5,000
shares from conversion of convertible bonds	= (60 × 110)	=	6,600
weighted ave. plus potential common shares outst.		=	**11,600**

Step 3: *Calculate Diluted EPS*

Diluted EPS = 17,760 / 11,600 = **$1.53.**

(Module 18.4, LOS 18.h)

Question #101 of 155

Question ID: 1457264

The following information pertains to Bender, Inc., for last year:

- Net income of $25 million.
- 1 million shares of $10 par value preferred stock outstanding paying a 10% dividend.
- 50 million shares of common stock outstanding at the beginning of the year.
- Issued an additional 5 million shares of common stock on 7/1.

What is Bender, Inc.'s basic earnings per share (EPS)?

A) $0.384.

B) $0.457.

C) $0.476.

Explanation

50,000,000 common shares × 12 months = 600,000,000

5,000,000 common shares × 6 months = 30,000,000 = 630,000,000

630,000,000 / 12 = 52,500,000 average shares

[$25,000,000(NI) − $1,000,000(preferred dividends)] / 52,500,000 shares = $24,000,000 / 52,5000,000 = $0.457

(Module 18.4, LOS 18.g)

Question #102 of 155

Question ID: 1457261

For a firm with a simple capital structure, all of the following are necessary to measure basic earnings per share (EPS) EXCEPT:

A) the timing and number of shares issued or repurchased during the year.

B) dividends paid to preferred shareholders.

C) dividends paid to common shareholders.

Explanation

Basic EPS = earnings available to common shareholders divided by the weighted average number of common shares outstanding. Earnings available to common shareholders equals net income minus preferred dividends.

(Module 18.4, LOS 18.g)

Question #103 of 155

Question ID: 1457236

When a firm recognizes revenue in excess of expenses on a product before cash is collected, what is the impact on the firm's assets and liabilities, ignoring taxes?

	Assets	Liabilities	
A)	No effect	Increase	✗
B)	Increase	Increase	✗
C)	Increase	No effect	✓

Explanation

When a firm recognizes revenue before cash is collected, equity increases (retained earnings) and assets increase (accounts receivable). When a product is sold on credit, accounts receivable (an asset) increases and inventory (also an asset) decreases. As long as the sale price of the product is more than the expense (reduction of inventory on the balance sheet), total assets will increase. Liabilities are not affected.

(Module 18.3, LOS 18.d)

Question #104 of 155

Question ID: 1462807

For a manufacturing company reporting under U.S. GAAP, interest received is *most likely* reported as:

A) both an operating cash flow and operating income. ✗

B) an operating cash flow but as non-operating income. ✓

C) an investing cash flow and as non-operating income. ✗

Explanation

Under U.S. GAAP, interest received is reported as an operating cash flow. For a non-financial services company, interest received is typically reported as non-operating income. (Module 18.3, LOS 18.f)

Question #105 of 155

Question ID: 1457343

Advantage Corp.'s capital structure was as follows:

	December 31, 2005	December 31, 2004
Outstanding shares of stock:		
Common	110,000	110,000
Convertible Preferred	10,000	10,000
% Convertible Bonds	$1,000,000	$1,000,000

During 2005, Advantage paid dividends of $3 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock. The 8% bonds are convertible into 30,000 shares of common stock. Net income for 2005 was $850,000. Assume the income tax rate is 30%.

Calculate Advantage's basic and diluted earnings per share (EPS) for 2005.

	Basic EPS	Diluted EPS	
A)	$7.45	$5.66	✓
B)	$7.45	$6.26	✗
C)	$6.31	$5.66	✗

Explanation

Basic EPS = net income − pref div / wt. ave. shares of common

[850,00 − (3 × 10,000)] / 110,000 = $7.45

Diluted EPS = [(net income − preferred dividends) + convertible preferred dividends + (convertible debt interest)(1 − t)] / [(weighted average shares) + (shares from conversion of conv. pfd shares) + (shares from conversion of conv. debt) + (shares issuable from stock options)]

[(850,000 − (3 × 10,000)) + 30,000 + (80,000)(1 − 0.3)] / [(110,000) + (20,000) + (30,000)] = $5.66.

(Module 18.4, LOS 18.h)

Question #106 of 155

Question ID: 1457241

A company changes from an incorrect method of accounting to an acceptable one. Which of the following statements about this change is *most accurate*?

A) It requires restatement of any prior period results that are presented in the current financial statements. ✓

B) It is an unusual or infrequent item and is reported in net income from continuing operations. ✗

C) It is a change in accounting principle and is reported below the line net of taxes. ✗

Explanation

If a company changes from an incorrect method of accounting to an acceptable one, the company must disclose the nature of the error and its effect on net income, and restate any prior period results that are presented in the current financial statements.

(Module 18.3, LOS 18.e)

Question #107 of 155

Question ID: 1457252

A firm's financial statements reflect the following:

Net income	$1,700,000
EBIT	$2,900,000
Effective tax rate	35%
Interest payments	$285,000
Common equity	$3,100,000
Total assets	$6,600,000
Preferred dividends paid	$1,100,000
Weighted avg. shares outstanding	523,000

Based on this information, what is the firm's basic EPS?

A) $2.75. ✗

B) $3.25. ✗

C) $1.15. ✓

Explanation

The firm's basic EPS = ($1,700,000 – $1,100,000) / (523,000) = $1.147.

(Module 18.4, LOS 18.g)

Question #108 of 155

Question ID: 1457351

Which of the following statements is CORRECT regarding the reporting of earnings per share (EPS)?

A) Basic EPS can be less than diluted EPS. ✗

B) The EPS when antidilutive securities are converted into shares of common stock is less than basic EPS. ✗

C) Diluted EPS must be less than or equal to basic EPS. ✓

Explanation

Antidilutive securities are securities that would increase EPS if exercised or converted to common stock.

(Module 18.4, LOS 18.h)

Question #109 of 155

Question ID: 1462815

In applying the treasury stock method, if warrants allow the purchase of 1 million shares at $42 per share when the average price is $56 per share, how many shares will be added to the firm's weighted average number of shares outstanding?

A) 250,000. ✓

B) 420,000. ✗

C) 1,000,000. ✗

Explanation

The treasury stock method would allow the 1 million additional shares to be partially offset by the number of shares that could be repurchased with the amount of money received for those shares. In this case, the 1 million shares issued would be offset by (1,000,000 × $42 / $56) or 750,000 shares. Shares added = 1,000,000 – 750,000 = 250,000.

(Module 18.4, LOS 18.h)

Question #110 of 155

Question ID: 1462816

Which of the following items would affect owners' equity and also appear on the income statement?

A) Dividends paid to shareholders. ✗

B) Unrealized gains and losses on available-for-sale securities. ✗

C) Unrealized gains and losses on trading securities. ✓

Explanation

Unrealized gains and losses from trading securities are reflected in the income statement and affect owners' equity. However, unrealized gains and losses from available-for-sale securities are included in other comprehensive income. Transactions included in other comprehensive income affect equity but not net income. Dividends paid to shareholders reduce owners' equity but not net income. (Module 18.5, LOS 18.l)

Question #111 of 155

Question ID: 1457287

Savannah Corp.'s financial accounts for the year ended December 31 included the following information:

- Net Income: $122,000
- Preferred Stock Dividends Paid: $35,000
- Common Stock Dividends Paid: $42,000
- Common Shares outstanding at January 1: 50,000
- 10% preferred $100 par value shares outstanding at January 1: 3,500

No stock transactions occurred during the year and all preferred stock dividends were paid. Basic earnings per share for Savannah are *closest* to:

A) $2.44. ✗

B) $0.90. ✗

C) $1.74. ✓

Explanation

Savannah Corp.'s basic EPS ((net income – preferred dividends) / weighted average number of common shares outstanding) was (($122,000 − $35,000) / $50,000 =) $1.74.

(Module 18.4, LOS 18.g)

Question #112 of 155

Question ID: 1457289

Selected information from Able Company's financial activities is as follows:

- Net Income was $720,000.
- 1,000,000 shares of common stock were outstanding on January 1.
- 1,000 shares of 8%, $1,000 par value preferred shares were outstanding on January 1.
- The tax rate was 40%.
- The average market price per share for the year was $20.
- 6,000 shares of 3%, $500 par value preferred shares, convertible into common shares at a rate of 40 common shares for each preferred share, were outstanding for the entire year.

Able's basic and diluted earnings per share (EPS) are *closest* to:

	Basic EPS	Diluted EPS	
A)	$0.55	$0.55	✗
B)	$0.55	$0.52	✓
C)	$0.64	$0.64	✗

Explanation

Able's basic earnings per share ((Net Income − Preferred Stock Dividends) / weighted average shares outstanding) for 2004 was [($720,000 − ($500 × 6,000 × 0.03) − ($1,000 × 1,000 × 0.08)] / 1,000,000 = $0.55. If the convertible preferred were converted to common stock on January 1, 6,000 × 40 = 240,000 additional shares would have been issued. Also, dividends on the convertible preferred would not have been paid.

So diluted EPS was ($720,000 − 80,000) / (1,000,000 + 240,000) = $0.52.

(Module 18.4, LOS 18.g)

Question #113 of 155

Question ID: 1457352

Which of the following statements regarding the treasury stock method of computing diluted shares is *least* accurate? The treasury stock method:

A) increases the total number of shares by less than the number that the exercise of the options would create. ✗

B) is used when the exercise price of the option is less than the average market price. ✗

assumes that the hypothetical funds received by the company from the exercise

C) of the options are used to sell shares of the company's common stock in the market at the average market price.

Explanation

The treasury stock method assumes any funds received by the company from the exercise of the options are used to *purchase* shares (**not** sell shares) of the company's common stock in the market at the average market price.

(Module 18.4, LOS 18.h)

Question #114 of 155

Question ID: 1457268

The ZZT Company went public on June 1, 2004, by issuing 25 million shares of common stock. In 2005, the firm raised additional capital by issuing 2 million shares of preferred stock. What is the weighted average number of common shares outstanding for the year ending December 31, 2005?

A) 14,583,333.

B) 25,000,000.

C) 10,416,667.

Explanation

The weighted average number of common shares outstanding is the number of shares outstanding during the year weighted by the portion of the year they were outstanding. Since no new common shares were issued in 2005, and there were 25 million shares at the end of 2004, there are 25 million shares at the end of 2005. Note that the preferred stock shares do not affect the common shares outstanding.

(Module 18.4, LOS 18.g)

Question #115 of 155

Question ID: 1457257

An analyst gathered the following information about a company:

- 01/01/04 - 50,000 shares issued and outstanding at the beginning of the year
- 04/01/04 - 5% stock dividend
- 10/01/04 - 10% stock dividend

What is the company's weighted average number of shares outstanding at the end of 2004?

A) 55,000.

B) 57,500.

C) 57,750.

Explanation

The weighted average number of common shares outstanding is the number of shares outstanding during the year weighted by the portion of the year they were outstanding. Dividends and splits are applied to all shares issued or repurchased and all original or adjusted shares outstanding prior to the split or dividend.

Step 1) Apply the 04/01/04 dividend to the beginning-of-year shares: Adjusted shares = 1.05 × 50,000 = 52,500

Step 2) Apply the 10/01/04 dividend the adjusted beginning-of-year shares. Adjusted beginning of year shares = 57,750 (= 1.1 × 52,500).

Step 3) Compute the weighted average number of shares. 57,750 × (12/12) = 57,750 shares.

(Module 18.4, LOS 18.g)

Question #116 of 155

Question ID: 1462812

A company had the following changes in its stock:

- The company had 2 million shares outstanding on December 31, 20X6.
- On March 31, 20X7, the company paid a 10% stock dividend.
- On June 30, 20X7, the company sold $10 million face value of 7% convertible debentures, convertible into common at $5 per share.
- On September 30, 20X7, the company issued and sold 100,000 shares of common stock.

The company should compute its 20X7 basic earnings per share based on:

A) 2,225,000 shares.

B) 2,250,000 shares.

C) 3,225,000 shares.

Explanation

Basic EPS does not consider potential dilution from convertible bonds.

Original shares = 2,000,000(12) =	24,000,000
+ Stock dividend = 200,000(12) =	2,400,000
+ New shares = 100,000(3) =	300,000
	26,700,000

$$\frac{26{,}700{,}000}{12} = 2{,}225{,}000$$

Alternatively, 2 million (1.1) + (1/4) (100,000) = 2.225 million. (Module 18.4, LOS 18.g)

Question #117 of 155

Question ID: 1457346

Which of the following statements about a firm with convertible preferred stock outstanding is *most* accurate?

A) If diluted and basic EPS are equal, the firm must report both basic and diluted EPS. ✓

B) Diluted EPS is calculated with net income minus preferred dividends in the numerator. ✗

C) If diluted EPS is less than basic EPS then the convertible preferred is said to be antidilutive. ✗

Explanation

A firm with any potentially dilutive securities outstanding must report both basic and diluted EPS, even if the two are equal. If convertible preferred stock is dilutive to earnings per share, the preferred dividend is added back to the numerator as if the preferred has been converted to common shares. If diluted EPS is less than basic EPS then the convertible preferred is said to be dilutive.

(Module 18.4, LOS 18.h)

Question #118 of 155

Question ID: 1457250

The following data pertains to the Megatron company:

- Net income equals $15,000.
- 5,000 shares of common stock issued on January 1.
- 10% stock dividend issued on June 1.
- 1000 shares of common stock were repurchased on July 1.
- 1000 shares of 10%, par $100 preferred stock each convertible into 8 shares of common were outstanding the whole year.

How many common shares should be used in computing the company's basic earnings per share (EPS)?

A) 5,500.

B) 4,500.

C) 5,000.

Explanation

1/1 5,500 shares issued (includes 10% stock dividend on 6/1) × 12 = 66,000

7/1 1,000 shares repurchased × 6 months = 6,000

66,000 − 6,000 = 60,000 shares

60,000 shares / 12 months = 5,000 average shares

(Module 18.4, LOS 18.g)

Question #119 of 155

Question ID: 1457310

Assume that the exercise price of an option is $11, and the average market price of the stock is $16. Assuming 1,039 options are outstanding during the entire year, what is the number of shares to be added to the denominator of the Diluted EPS?

A) 714.

B) 1,039.

C) 325.

Explanation

(1,039 options)($11) = $11,429

$11,429 / $16 per share

1039 – 714 = 325 shares or [(16 – 11) / 16]1,039 = 325.

(Module 18.4, LOS 18.h)

Question #120 of 155

Question ID: 1457233

Which expense recognition method is *most appropriate* for intangible assets with indefinite lives?

A) Test for impairment but do not amortize. ✓

B) Use accelerated amortization for tax reporting and straight-line amortization for financial reporting. ✗

C) Use straight-line amortization. ✗

Explanation

Under IFRS and U.S. GAAP, intangible assets with indefinite lives (e.g., goodwill) are not amortized but are tested for impairment at least annually.

(Module 18.3, LOS 18.d)

Question #121 of 155

Question ID: 1457279

Which type of a capital structure contains no dilutive securities?

A) Complex. ✗

B) Simple. ✓

C) Basic. ✗

Explanation

A complex capital structure contains potentially dilutive securities such as options, warrants, or convertible securities. There is no *basic* capital structure but there are basic earnings per share which does NOT consider the effects of any dilutive securities in the computation of EPS.

(Module 18.4, LOS 18.g)

Question #122 of 155

Question ID: 1457340

Which of the following statements about the earnings per share calculation are *most accurate*?

A) If the diluted EPS is less than the basic EPS, then the diluted EPS is said to be anti-dilutive. ✗

B) None of these choices are correct. ✓

C) When calculating diluted EPS you must add the shares created from the conversion of the bonds to the denominator and the interest expense times the tax rate to the numerator. ✗

Explanation

Anti-dilutive is when dilutive EPS > basic EPS. When calculating diluted EPS, you must add the shares created from the conversion of the bonds to the denominator and the interest (1 – tax rate) to the numerator.

(Module 18.4, LOS 18.h)

Question #123 of 155

Question ID: 1457245

Red Oak Corporation is a furniture manufacturer located in Canada. Red Oak is financed with a combination of debt and equity. The debt consists of unsecured zero-coupon bonds that mature in 20 years. For income tax purposes, interest on the bonds is deductible when accrued. Red Oak's equity consists of common stock and preferred stock. No dividends have ever been paid on Red Oak's common stock; however, dividends are paid quarterly to the preferred shareholders. Should the accrued interest on the zero-coupon bonds and the dividends paid to the preferred shareholders be reported as a nonoperating component of Red Oak's net income?

	Accrued interest	Preferred dividends	
A)	No	Yes	✗
B)	Yes	No	✓
C)	Yes	Yes	✗

Explanation

Since Red Oak is a nonfinancial firm, the accrued interest is considered a nonoperating activity, related to how the firm is financed. Dividends paid to preferred shareholders do not affect net income.

(Module 18.3, LOS 18.f)

Question #124 of 155

Question ID: 1457307

When considering convertible preferred stock which of the following components of the earnings per share (EPS) equation needs to be adjusted to calculate diluted earnings per share?

A) The denominator.

B) The numerator and denominator.

C) The numerator.

Explanation

The numerator will increase because earnings available to the common shareholder are increased by the reduction in preferred dividends. The denominator increases because the weighted average number of shares increases upon conversion of the preferred stock.

(Module 18.4, LOS 18.h)

Question #125 of 155

Question ID: 1457342

Securities are considered to be dilutive to earnings per share if:

A) they can be converted to common shares now or at any time in the future.

B) converting them to common shares would decrease earnings available to common shareholders.

C) converting them to common shares would actually reduce earnings per share, compared to basic earnings per share.

Explanation

Securities are dilutive if they would decrease EPS (compared to basic EPS) if they are exercised or converted to common stock. *Potentially dilutive* securities include any that can be converted to common shares now or at any time in the future. Assuming conversion of securities such as convertible bonds or convertible preferred stock typically increases earnings available to common shareholders; these securities are dilutive to EPS if they increase common shares relatively more than they increase earnings available to common.

(Module 18.4, LOS 18.h)

Question #126 of 155

Question ID: 1457336

An analyst has gathered the following information about Artcraft, Inc. for the year:

- Net income of $30,000.
- 5,000 shares of common stock and 500 shares of 8%, $90 par convertible preferred stock outstanding during the whole year.
- Each share of convertible preferred can be converted into 4 shares of common stock.
- Last year, Artcraft issued at par, $60,000 total face value of 6.0% convertible bonds, with each of the 60 bonds convertible into 110 shares of the Artcraft common stock.

If Artcraft's effective tax rate is 40%, what will Artcraft report as diluted earnings per share (EPS)?

A) $2.36.

B) $3.12.

C) $3.37.

Explanation

Diluted EPS = adjusted earnings after conversion (EAC) / weighted average plus potential common shares outstanding.

Step 1: *Calculate Adjusted EAC*

adjusted EAC:		net income - preferred dividends
	+	dividends on convertible preferred stock
	+	after-tax interest on convertible debt
	=	adjusted earnings available for common shares

preferred dividends = convertible preferred dividends = (0.08)(90)(500) = 3,600

convertible debt interest = (60,000)(0.06)(1 – 0.40) = 2,160

adjusted EAC = (30,000 – 3,600 + 3,600 + 2,160) = **$32,160**

Step 2: *Calculate Weighted average plus potential common shares outstanding.*

weighted average common shares			=	5,000
shares from conversion of convertible preferred stock	=	(500 × 4)	=	2,000
shares from conversion of convertible bonds	=	(60 × 110)	=	6,600
weighted ave. plus potential			=	**13,600**

common shares outst.				

Step 3: *Calculate Diluted EPS*

Diluted EPS = 32,160 / 13,600 = **$2.36.**

(Module 18.4, LOS 18.h)

Question #127 of 155

Question ID: 1457359

Moulding Company's net income was $13,820,000 with 2,600,000 shares outstanding. The average share price for the year was $58.00. Moulding had 10,000 options to purchase 10 shares each at $40 per share outstanding the entire year. Moulding Company's diluted earnings per share are *closest* to:

A) $5.25.

B) $5.32.

C) $3.71.

Explanation

Moulding's basic EPS (net income / weighted average common shares outstanding) was $13,820,000 / 2,600,000 = $5.32.

Using the treasury stock method to compute diluted EPS, if the options were exercised, cash inflow would be 10,000 × 10 × $40 = $4,000,000. Based on the average share price of $58.00, the number of Moulding shares that can be purchased with the cash flow is $4,000,000 / $58 = 68,966. The number of shares that would have been created is 100,000 – 68,966 = 31,034. Diluted EPS was $13,820,000 / (2,600,000 + 31,034) = $5.25.

(Module 18.4, LOS 18.h)

Question #128 of 155

Question ID: 1457258

A firm has a weighted average number of 20,000 common shares selling at an average of $10 throughout the year and 11,000, 10%, $100 par value preferred shares. If the firm earns $210,000 after taxes, what is its Basic EPS?

A) $5.00 / share.

B) $7.50 / share.

C) $10.50 / share.

Explanation

(210,000 − 110,000) / 20,000 = $5 share

(Module 18.4, LOS 18.g)

Question #129 of 155

Question ID: 1457345

Which of the following statements regarding basic and diluted EPS is *least* accurate?

A) A simple capital structure contains no potentially dilutive securities.

B) Antidilutive securities decrease EPS if they are exercised or converted.

C) Dilutive securities decrease EPS if they are exercised or converted to common stock.

Explanation

Antidilutive securities *increase* EPS if exercised or converted to common stock.

(Module 18.4, LOS 18.h)

Question #130 of 155

Question ID: 1457260

As of the beginning of the year HalfPass Productions, Inc., had the following complex capital structure:

- 3,000,000 common shares outstanding.
- 175,000 options with an exercise price of $22.
- 250,000 warrants with an exercise price of $18.

During the year:

- On March 1, the company issued 100,000 new shares of common stock.
- On July 1, the board of directors declared a 15% stock dividend.
- On September 1, the company repurchased 125,000 shares.
- Net income (after-tax) for the year was $7,500,000.
- The company paid common dividends of $2,750,000 and preferred dividends of $1,300,000.
- The average market price for the common stock was $25 per share.

Assume the fiscal year is January 1 through December 31. At year end, HalfPass's basic EPS is *closest* to:

A) $1.66. ✗

B) $1.94. ✗

C) $1.77. ✓

Explanation

The question is asking for basic *EPS*. Thus we can ignore the dilutive options and warrants.

Basic EPS = (net income – preferred dividends) / weighted average common shares outstanding

- The numerator = $7.5 million – $1.3 million = $6.2 million
- Calculating the denominator is a bit more work (calculation detailed in table below):

Event	Notes	Million Shares	# Months Outstanding	Total
Beginning Bal. (BB)		3.000	12	36.000
New issue (March 01)		0.100	10	1.00
Stock Dividend	15% on BB	0.450	12	5.400
Stock Dividend	15% on new issue	0.015	10	0.150
Repurchase (Sept .1)		-0.125	4	-0.500
			Total	*42.050*

Average shares = 42,050,000 / 12 = 3,504,167

Basic EPS = $6.2 million / 3.504 million = $1.77

(Module 18.4, LOS 18.g)

Question #131 of 155

Question ID: 1462808

A company has the following sequence of events regarding its stock:

- The company had 1,000,000 shares outstanding at the beginning of the year.
- On June 30, the company declared and issued a 10% stock dividend.
- On September 30, the company sold 400,000 shares of common stock at par.

The number of shares that should be used to compute basic earnings per share at year end is:

A) 1,000,000. ✗

B) 1,200,000. ✓

C) 1,100,000. ✗

Explanation

original shares of common stock	= 1,000,000(12)	= 12,000,000
stock dividend	= 100,000(12)	= 1,200,000
new shares of common stock	= 400,000(3)	= 1,200,000
total shares of common stock	$= \frac{14,400,000}{12}$	= 1,200,000

Stock dividends are assumed to have been outstanding since the beginning of the year. (Module 18.4, LOS 18.g)

Question #132 of 155

Question ID: 1457341

Securities that improve basic per share earnings, or reduce per share losses, if they are exercised or converted to common stock are called:

A) embedded securities.

B) dilutive securities.

C) antidilutive securities.

Explanation

Antidilutive securities, upon exercise, increase basic EPS or decrease per share losses. Shares from conversion are not included in the calculation of basic or diluted EPS.

(Module 18.4, LOS 18.h)

Question #133 of 155

Question ID: 1457292

Zichron, Inc., had the following equity accounts on December 31:

- Common stock: 20,000 shares.
- Preferred stock A: 10,000 shares convertible into common on a 2 for 1 basis, dividend of $40,000 was declared during the year.
- Preferred stock B: 10,000 shares, convertible to common on a 4 for 1 basis, dividend of $5,000 was declared during the year.
- The company reported net income of $120,000 and paid a $20,000 dividend to its common shareholders.

Diluted earnings per share for the year are:

A) $1.33.

B) $1.50.

C) $3.00.

Explanation

Basic EPS = ($120,000 – $40,000 – $5,000) / 20,000 = $3.75.

Convertible preferred stock A: $40,000 / 2(10,000) = $2.00, which is less than basic EPS so the convertible preferred stock is dilutive.

Convertible preferred stock B: $5,000 / 4($10,000) = $0.125, which is less than basic EPS so the convertible preferred stock is dilutive.

Diluted EPS = $120,000 / [20,000 + 2(10,000) + 4(10,000)] = $1.50.

(Module 18.4, LOS 18.g)

Question #134 of 155

Question ID: 1457249

A company has the following sequence of events regarding their stock:

- One million shares outstanding at the beginning of the year.
- On June 30th, they declared and issued a 10% stock dividend.
- On September 30th, they sold 400,000 shares of common stock at par.

Basic earnings per share at year-end will be computed on how many shares?

A) 1,000,000.

B) 1,100,000.

C) 1,200,000.

Explanation

$$1{,}000{,}000(12) = 12{,}000{,}000$$
$$100{,}000(12) = 1{,}200{,}000$$
$$400{,}000(3) = 1{,}200{,}000$$
$$\text{Total} = \frac{14{,}400{,}000}{12} = 1{,}200{,}000$$

(Module 18.4, LOS 18.g)

Question #135 of 155

Question ID: 1457369

For the year ended December 31, 2007, Cobra Company reported the following financial information:

Revenue	$100,000
Cost of goods sold	40,000
Operating expenses	20,000
Unrealized gain from foreign currency translation	5,000
Unrealized loss on cash flow hedging derivatives	3,000
Dividends paid to common shareholders	7,500
Realized gain on sale of equipment	1,000

Ignoring taxes, calculate Cobra's net income and comprehensive income for 2007.

	Net income	Comprehensive income	
A)	$40,000	$43,000	✗
B)	$41,000	$2,000	✗
C)	$41,000	$43,000	✓

Explanation

Net income is equal to $41,000 ($100,000 revenue – $40,000 COGS – $20,000 operating expenses + $1,000 realized gain on sale of equipment). Comprehensive income includes all transactions that affect stockholders' equity except transactions with shareholders. Comprehensive income includes net income, unrealized gains and losses from available-for-sales securities, unrealized gains and losses from cash flow hedging derivatives, and gains and losses from foreign currency translation. Thus, comprehensive income is equal to $43,000 ($41,000 net income + $5,000 unrealized gain from foreign currency translation – $3,000 unrealized loss from cash flow hedging derivatives). Dividends paid is a transaction with shareholders and is not included in comprehensive income.

(Module 18.5, LOS 18.k)

Question #136 of 155

Question ID: 1457269

The following information pertains the QRK Company:

- One million shares of common stock outstanding at the beginning of 2005.
- 200,000 shares issued on the last day of March.
- 500,000 shares issued on the last day of June.
- 800,000 shares issued on the last day of September.

What is the number of shares that should be used to compute 2005 earnings per share for the QRK Company?

A) 1.6 million.

B) 1.9 million.

C) 2.5 million.

Explanation

The weighted average number of common shares outstanding is the number of shares outstanding during the year weighted by the portion of the year they were outstanding. For the QRK Company, the weighted number of shares outstanding is the original one million shares plus 150,000 shares for the end-of-March issue (= 200,000 × 9/12), plus 250,000 shares for the end-of-June issue (= 500,000 × 6/12), plus 200,000 shares for the end-of-September issue (= 800,000 × 3/12), or 1.6 million shares.

(Module 18.4, LOS 18.g)

Question #137 of 155

Question ID: 1457293

Trotters Diversified has 10,000 convertible bonds with a 6.0% coupon and $1,000 par value, each convertible into 8 shares of common stock. How many shares related to the convertible bonds should be included in the denominator of basic EPS?

A) 0.

B) 10,000.

C) 80,000.

Explanation

The calculation for basic EPS is not adjusted for the impact of potentially dilutive securities.

(Module 18.4, LOS 18.g)

Question #138 of 155

Question ID: 1457253

Maine Company's stock transactions during the year are described below:

January 1	100,000 common shares outstanding
March 1	2 for 1 stock split
August 1	10% stock dividend

The weighted average number of shares outstanding used to calculate earnings per share is:

A) 211,111.

B) 201,666.

C) 220,000.

Explanation

The January 1 balance of common shares outstanding is adjusted retroactively for both stock dividends and stock splits. The weighted average shares outstanding for the year = 100,000 × 2 × 1.1 = 220,000.

(Module 18.4, LOS 18.g)

Question #139 of 155

Question ID: 1457288

Lawson, Inc.'s net income for the year was $1,060,000 with 420,000 shares of common stock outstanding. Lawson has 2,000 shares of 8%, $1,000 par value convertible preferred stock that were outstanding the entire year. Each share of preferred is convertible into 50 shares of common stock. Lawson's diluted earnings per share are *closest* to:

A) $1.94.

B) $2.04.

C) $2.14.

Explanation

Lawson's basic EPS ((net income − preferred dividends) / weighted average common shares outstanding) is ($1,060,000 − (2,000 × $1,000 × 0.08)) / 420,000 = $2.14. To calculate diluted EPS the convertible preferred shares are presumed to have been converted, the preferred dividends paid are added back to the numerator of the EPS equation, and the additional common shares are added to the denominator of the equation. Lawson's diluted EPS is $1,060,000 / (420,000 + 100,000) = $2.04.

(Module 18.4, LOS 18.g)

Question #140 of 155

Question ID: 1457333

Selected information from Baltimore Corp's financial activities in the year 2004 is as follows:

- Net income was $4,200,000.
- 750,000 shares of common stock were outstanding on January 1.
- The average market price per share was $50 in 2004.
- Dividends were paid in 2004.

10,000 warrants, which allowed the holder to purchase 10 shares of common stock for each warrant held at a price of $40 per common share, were outstanding the entire year.

Baltimore's diluted earnings per share (Diluted EPS) for 2004 is *closest* to:

A) $4.94. ✗

B) $5.45. ✓

C) $5.60. ✗

Explanation

Baltimore's basic earnings per share (EPS) (net income / weighted average shares outstanding) for 2004 was $4,200,000 / 750,000 = $5.60.

To calculate diluted EPS, we use the treasury stock method to account for the warrants:

- Number of common shares created if options are exercised = 10,000 × 10 = 100,000
- Cash inflow if warrants are exercised = $40 × 100,000 = $4,000,000
- Shares purchased with these funds = $4,000,000 / 50 = 80,000
- Net increase in shares outstanding = 100,000 – 80,000 = 20,000

Diluted EPS = $4,200,000 / (750,000 + 20,000) = $5.45.

(Module 18.4, LOS 18.h)

Question #141 of 155

Question ID: 1457235

Under accrual accounting, revenues are recognized in the same period in which the associated:

A) cash is collected.

B) expenses are incurred.

C) invoices are billed.

Explanation

Accrual accounting is based on the matching principle, under which revenues are recognized in the same period that the expenses are incurred to generate those revenues.

(Module 18.3, LOS 18.d)

Question #142 of 155

Question ID: 1457227

The "All Faiths" church is building a new church for $2 million on land acquired several years ago. The contractor estimates the cost at $1.3 million and the project is to be completed over a 2-year period with the payments split evenly between the 2 years. During the first year, the total costs incurred were $700,000. During the second year the contractor experienced cost overruns and costs incurred were $1.0 million. Using the percentage-of-completion method, how much revenue and income should the contractor recognize in the second year of the project?

	Revenue	Income
A)	$1,000,000	$0
B)	$1,076,923	$376,923
C)	$923,077	-$76,923

Explanation

During the first year, the revenue was 700,000 / 1,300,000 × 2,000,000 = 1,076,923

The total revenue for both years = $2,000,000

The second year revenue was 2,000,000 – 1,076,923 = $923,077

The second year income = revenues − costs = 923,077 – 1,000,000 = $-76,923

(Module 18.2, LOS 18.c)

Question #143 of 155

Question ID: 1457276

The SSP Company had 5 million shares outstanding on January 1. On February 15 the board of directors approved a 3:2 stock split, effective April 1. What is the weighted average number of shares outstanding for the SSP Company for year-end?

A) 6,875,000 shares.

B) 7,500,000 shares.

C) 5,625,000 shares.

Explanation

Stock splits and stock dividends are applied to all shares that existed at the beginning of the period and shares that were issued or repurchased during the period, *but prior to the split or dividend*. For SSP, the 5 million beginning-of-year shares outstanding are adjusted to 7.5 million shares (5.0 × 3/2) as a result of the 3:2 split.

(Module 18.4, LOS 18.g)

Question #144 of 155

Question ID: 1457319

Ajax Company's capital structure was as follows:

	December 31, 2004	*December 31, 2003*
Outstanding shares of stock:		
Common	200,000	200,000
Convertible preferred	5,000	5,000
6% Convertible Bonds	$500,000	$500,000

- During 2004, Ajax paid dividends of $2.00 per share on its preferred stock.
- The preferred shares are convertible into 10,000 shares of common stock.
- The 6% bonds are convertible into 15,000 shares of common stock.
- Net income for 2004 was $400,000.
- Assume that income tax rate is 40%.

Ajax's basic and diluted earnings per share for 2004 are:

	Basic EPS	Diluted EPS	
A)	$1.80	$1.86	✗
B)	$1.95	$1.86	✓
C)	$1.95	$1.95	✗

Explanation

Basic EPS: [400,000 − 10,000] / 200,000 shares = $1.95 per share

Diluted EPS: [400,000 + (30,000 × 0.6)] / [200,000 + 10,000 + 15,000] = $1.86 per share

(Module 18.4, LOS 18.h)

Question #145 of 155

Question ID: 1462804

On a firm's income statement, sales minus cost of goods sold, minus selling, general, and administrative expenses, is *most appropriately* referred to as:

A) gross profit. ✗

B) income before tax. ✗

C) operating profit. ✓

Explanation

This difference describes operating profit. (Module 18.1, LOS 18.a)

Question #146 of 155

Question ID: 1457285

Sampson Corp. had 500,000 shares of common stock outstanding at the beginning of the year. The average market price was $20.

- On April 1, Sampson issued 100,000 shares of $1000 par value 10 percent preferred stock.
- On July 1, Sampson issued 200,000 warrants to purchase 10 shares of common stock each at $22 per share.
- On October 1, Sampson repurchased 60,000 of common stock as treasury stock for $15 per share.

The weighted average common shares outstanding Sampson should use to compute basic earnings per share (EPS) was:

A) 600,000. ✗

B) 515,000. ✗

C) 485,000. ✓

Explanation

Only the October 1 transaction affects the weighted average common shares outstanding because the April 1 transaction would not affect the number of shares outstanding and the July 1 transaction involves warrants which would not be included in the basic EPS calculation. The computation for basic EPS is [(500,000 × 12) − (60,000 × 3)] / 12 = 485,000.

(Module 18.4, LOS 18.g)

Question #147 of 155

Question ID: 1457275

A firm has had the following numbers of shares outstanding during the year:

Beginning of year	10,000,000 shares
Issued on April 1	500,000 shares
Split 2 for 1 on July 1	
Issued on October 1	100,000 shares
Split 2 for 1 on December 31	

Based on this information, what is the weighted number of shares outstanding for the year?

A) 20,780,000.

B) 41,550,000.

C) 42,400,000.

Explanation

Outstanding all year	10,000,000 × 2 × 2 × 1	40,000,000
Outstanding for 0.75 years	500,000 × 2 × 2 × 0.75	1,500,000
Outstanding for 0.25 years	100,000 × 2 × 0.25	50,000
Weighted average number of shares for year:		**41,550,000**

(Module 18.4, LOS 18.g)

Question #148 of 155

Question ID: 1457311

Assume that the exercise price of an option is $10, and the average market price of the stock is $13. Assuming 999 options are outstanding during the entire year, what is the number of shares to be added to the denominator of the diluted earnings per share (EPS)?

A) 231.

B) 768.

C) 999.

Explanation

(999)(10) = 9,990

9,990 / 13 = 768

999 − 768 = 231

(Module 18.4, LOS 18.h)

Question #149 of 155

Question ID: 1457273

At the beginning of this year Aristotle Co. had 400,000 shares of common stock outstanding. During the year, Aristotle paid a 10 percent stock dividend on May 31, issued 90,000 new common shares on June 30, and repurchased 12,000 shares on December 1. The number of shares Aristotle should use in computing earnings per share at the end of the year is:

A) 476,000.

B) 484,000.

C) 475,000.

Explanation

[400,000 shares × 12 months + 40,000 × 12 months + 90,000 × 6 months - (12,000 × 1 months)] divided by 12 = 484,000 shares.

(Module 18.4, LOS 18.g)

Question #150 of 155

Question ID: 1457280

Juniper Corp's stock transactions during the year 20X4 were as follows:

January 1	540,000 shares issued and outstanding
March 1	50 percent stock dividend
July 1	180,000 treasury shares reacquired
October 1	60,000 treasury shares reissued

When computing for earnings per share (EPS) computation purposes, what was Juniper's weighted average number of shares outstanding during 20X4?

A) 735,000.

B) 870,000.

C) 930,000.

Explanation

The January 1 balance is adjusted retroactively for the stock dividend and (540,000 × 1.5) = 810,000 shares are treated as outstanding from January 1. The weighted average number of shares is computed by multiplying the shares by the number of months held, as follows:

January 1	Initial shares	(810,000 × 12) =	9,720,000
July 1	Reacquired shares	(-180,000 × 6) =	1,080,000
October 1	Reissued shares	(60,000 × 3) =	180,000
			8,820,000

Weighted average shares was (8,820,000 / 12) = 735,000 shares.

(Module 18.4, LOS 18.g)

Question #151 of 155

Question ID: 1457354

All of the following are considered a potentially dilutive securities EXCEPT:

A) preferred stock.

B) warrants.

C) stock options.

Explanation

Not all preferred stock is dilutive. Only *convertible* preferred stock is potentially dilutive.

(Module 18.4, LOS 18.h)

Question #152 of 155

Question ID: 1457294

The following information is for Trotters Diversified as of year-end:

- Average common shares outstanding of 5.0 million.
- Average market price for common stock of $35.00 per share.
- Net income of $9.0 million.
- Common stock dividends paid of $1.2 million.
- Tax rate of 40%.
- 500,000 shares of cumulative convertible preferred stock with $30 par value and 10% dividend. Each preferred share is convertible into 5 common shares. Preferred dividends of $1.5 million were paid.
- 10,000 convertible $1,000 par bonds with a 6.0% coupon, each convertible into 8 shares of common stock.
- 400,000 stock options with an exercise price of $32.00 per share.
- All of these securities were outstanding for the full year.

Diluted EPS for Trotters Diversified is *closest* to:

A) $1.50.

B) $1.19.

C) $1.23.

Explanation

Only the options and convertible preferred stock are dilutive. First, calculate basic EPS to use as a benchmark to determine dilutive capital components.

> Basic EPS = (net income – preferred dividends) / weighted average common shares outstanding = (9.0 – 1.5) / 5.0 = $1.50.

Next, check for dilution.

- The stock options are dilutive because the exercise price is less than the average stock price. There is no numerator impact from the options. The denominator impact = # options – [(# options × exercise price) / average stock price)] = 400,000 – [(400,000 × 32) / 35] = 34,286 or 0.034 million.
- To check whether the convertible preferred stock is dilutive we need to determine whether it decreases EPS. To the numerator, we add back the preferred dividend. The denominator impact = (# preferred shares × conversion rate) = 500,000 × 5 = 2,500,000, or 2.5 million. Then, EPS = (9.0 – 1.5 + 1.5) / (5.0 + 2.5) = $1.20. Thus the convertible preferred stock is dilutive.
- To check whether the convertible bonds are dilutive we need to determine whether they decrease EPS. To the numerator, we add back the after-tax impact of the coupon, or (face value × coupon × (1 – t)), or (10,000 bonds × 1,000 par × 0.06 coupon × 0.6) = 360,000, or $0.360 million. The denominator impact = (# convertible bonds × conversion rate) = 10,000 × 8 = 80,000, or 0.080 million. Then, EPS = (9.0 – 1.5 + 0.360) / (5.0 + 0.080) = $1.55. Thus the bonds are antidilutive.

Finally, calculate diluted EPS:

> Diluted EPS = (9.0 – 1.5 + 1.5) / (5.0 + 2.5 + 0.034) = $1.1946.

(Module 18.4, LOS 18.g)

Question #153 of 155

Question ID: 1457284

Which of the following securities would *least likely* be found in a simple capital structure?

A) 3%, $100 par value convertible preferred. ✓

B) 6%, $5000 par value putable bond. ✗

C) 7%, $100 par value non convertible preferred. ✗

Explanation

A simple capital structure contains no potentially dilutive securities such as stock options, warrants, or convertible preferred stock.

(Module 18.4, LOS 18.g)

Question #154 of 155

Question ID: 1457230

The Better Building Company has a contract to build a building for $100 million. The estimate of the cost of the project is $75 million. In the first year of the project, BB had costs of $30 million. The Better Building Company's reported profit for the first year of the contract, using the percentage-of-completion method, is:

A) $20 million.

B) $10 million.

C) $0.

Explanation

Reported profit (in millions) = ($30 / $75)($100 − 75) = $10.

(Module 18.2, LOS 18.c)

Question #155 of 155

Question ID: 1457315

The Gaffe Company had net income of $1,500,000. Gaffe paid preferred dividends of $5 on each of the 100,000 preferred shares. Each preferred share is convertible into 20 common shares. There are 1 million Gaffe common shares outstanding. In addition to the common and preferred stock, Gaffe has $25 million of 4% bonds outstanding. If Gaffe's tax rate is 40%, what is its diluted earnings per share?

A) $0.33.

B) $0.50.

C) $1.00.

Explanation

The preferred shares are convertible into 100,000 × 20 = 2 million common shares. They are dilutive since:

$$\text{Basic EPS} = \frac{\$1{,}000{,}000}{1{,}000{,}000} = \$1.00$$

$$\text{Diluted EPS} = \frac{\$1{,}500{,}000}{3{,}000{,}000} = \$0.50 \text{ which is less.}$$

(Module 18.4, LOS 18.h)