




Question #1 of 170

The standard equation for computing basic earnings per share (EPS) is:

- A) $[\text{Net Income} - \text{Preferred Dividends}] / \text{Weighted Average Number of Common Shares Outstanding}$. 
- B) $[\text{Net Income} - \text{Common Dividends}] / \text{Weighted Average Number of Common Shares Outstanding}$. 
- C) $[\text{Sales} - \text{Cost of Goods Sold}] / \text{Number of Preferred Shares Outstanding}$. 

Explanation




The basic EPS calculation does not consider the effects of any dilutive securities in the computation.

Basic EPS = $[\text{Net Income} - \text{Preferred Dividends}] / \text{Weighted Average Number of Common Shares Outstanding}$.

(Study Session 7, Module 23.5, LOS 23.h)

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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) \$3.80. 
- C) \$3.45. 

Explanation

Orange's basic EPS ((net income – preferred dividends) / weighted average common shares outstanding) is $[(\$7,600,000 - (10,000 \times \$1,000 \times 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.

(Study Session 7, Module 23.5, LOS 23.i)

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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) \$20.00.



C) \$14.67.



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 $100,000 + (30,000 \times 4 / 12) = 110,000$. Basic EPS is $(\$2,800,000 - (10,000 \times \$1,000 \times 0.06)) / 110,000 = \20.00 .

If the warrants were exercised, cash inflow would be $10,000 \times \$150 \times 10 = \$15,000,000$ for $10 \times 10,000 = 100,000$ 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 .

(Study Session 7, Module 23.5, LOS 23.i)

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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) \$4.50.



B) \$2.81.



C) \$3.38.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #5 of 170

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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #6 of 170

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



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



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #7 of 170

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 $[(8 - 5) / 8]816 = 306$.

(Study Session 7, Module 23.5, LOS 23.i)

Question #8 of 170

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) Diluted EPS is less than basic EPS. 
- B) All of Valuable's potentially dilutive securities are antidilutive. 
- 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #9 of 170

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) 1,325,000 shares. 
- B) 1,500,000 shares. 
- C) 1,200,000 shares. 




Explanation

Weighted average shares = $1,000,000 + (0.75) 300,000 + (0.5) 200,000 = 1,325,000$ shares

(Study Session 7, Module 23.5, LOS 23.h)

Question #10 of 170

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) 10,000. 
- B) 0 
- C) 80,000. 

Explanation

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



(Study Session 7, Module 23.5, LOS 23.h)

Question #11 of 170

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?

	<u>Basic EPS</u>	<u>Diluted EPS</u>	
A) \$3.97		\$3.06	
B) \$4.12		\$3.06	
C) \$4.12		\$2.95	

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.

$$\text{Basic EPS} = (\$200,000 - \$35,045) / 40,045 = 164,955 / 40,045 = \$4.12$$

Diluted EPS:

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

- 6.125% convertible bonds:

$$(\text{Convertible debt interest})(1 - \text{tax rate}) / \text{Common shares if converted}$$

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

$$= \$1.1136$$

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

- 6.25% convertible preferred stock:

$$\text{Preferred dividend} / \text{Common shares if converted}$$

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

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

- 8% convertible preferred stock:

$$\text{Preferred dividend} / \text{Common shares if converted}$$

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

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:

$$(100 \text{ bonds})(33) = 3,300 \text{ common shares}$$

- 6.25% convertible preferred stock:

$$(2,315 \text{ preferred shares})(3.3) = 7,640 \text{ common shares}$$

- 8% convertible preferred stock:

$$(2,572 \text{ preferred shares})(5) = 12,860 \text{ common shares}$$




- Warrants:

$$[(\$52 - \$38) / \$52] \times 9,986 = 2,689 \text{ common shares}$$

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

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A complex capital structure, for purposes of determining disclosure of diluted Earnings Per Share, is distinguished from a simple capital structure by the:

- A) company having preferred stock outstanding. 
- B) company's use of debt to finance its operations. 
- C) company having issued warrants, convertible securities, or options. 

Explanation

A complex structure contains potentially dilutive securities such as options warrants or convertible securities. Where as simple capital structures contain no potentially dilutive securities and contains only common stock and non-convertible securities.




(Study Session 7, Module 23.5, LOS 23.h)

Question #13 of 170

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) 515,000. 
- B) 485,000. 
- C) 600,000. 

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 $[(500,000 \times 12) - (60,000 \times 3)] / 12 = 485,000$.

(Study Session 7, Module 23.5, LOS 23.h)

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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) \$10,000.00



C) \$20,000.00



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.

(Study Session 7, Module 23.2, LOS 23.c)

Question #15 of 170

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

A) neither basic nor diluted EPS.



B) diluted EPS but not basic EPS.



C) basic EPS but not 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #16 of 170

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) Cost recovery method.



C) Weighted average 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #17 of 170

In calculating the numerator for diluted earnings per share, the dividends on convertible preferred stock are:

- A) added to earnings available to common shareholders with an adjustment for taxes. 
- B) subtracted from earnings available to common shareholders without an adjustment for taxes. 
- C) added to 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)]

(Study Session 7, Module 23.5, LOS 23.i)

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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 \times \$1,000 \times 0.06)(1 - 0.40)] / [400,000 + (2,000 \times 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #19 of 170

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) \$3.67. 
- B) \$4.00. 
- C) \$3.38. 




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 \text{ million} / [2 \text{ million} + (4/12)(600,000)] = 8.8/2.2 = \4.00 .

(Study Session 7, Module 23.5, LOS 23.h)

Question #20 of 170

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

- A) 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. 
- B) None of these choices are correct. 
- C) If the diluted EPS is less than the basic EPS, then the diluted EPS is said to be anti-dilutive. 

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.




(Study Session 7, Module 23.5, LOS 23.i)

Question #21 of 170

Jerry Krome, CFA, is an equity analyst. The head of research at Krome's firm composes a memo that contains the following statements:

- To the extent that management has discretion over the firm's revenue recognition, an analyst should consider policies that recognize revenue later to be more conservative than policies that recognize revenue sooner.
- When comparing the performance of companies, an analyst can use the information in the financial statement disclosures to adjust the financial statements for differences in revenue recognition policies.

With regard to the implications of revenue recognition policies for financial analysis, Krome should agree with:

- A) only one of these statements. 
- B) neither of these statements. 
- C) both of these statements. 

Explanation

Because revenue recognition often relies on judgment and estimates from management, it is not always possible to calculate the appropriate adjustments that would account for the differences between companies' revenue recognition policies. An analyst should use the policies disclosed in companies' financial statement footnotes to understand the degree to which their revenue recognition is conservative or aggressive. In general, recognizing revenue sooner is considered aggressive and recognizing revenue later is considered conservative.

(Study Session 7, Module 23.3, LOS 23.b)

Question #22 of 170

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?

	<u>Cash flow hedging derivatives</u>	<u>Available-for-sale securities</u>	
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.

(Study Session 7, Module 23.6, LOS 23.m)

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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 is a change in accounting principle and is reported below the line net of taxes. | ✗ |
| B) | It is an unusual or infrequent item and is reported in net income from continuing operations. | ✗ |
| C) | It requires restatement of any prior period results that are presented in the current financial statements. | ✓ |

Explanation

This is the correct treatment of this change. 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.

(Study Session 7, Module 23.4, LOS 23.f)

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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) 1,200,000.



B) 1,100,000.



C) 1,000,000.



Explanation

$$1,000,000(12) = 12,000,000$$

$$100,000(12) = 1,200,000$$

$$400,000(3) = 1,200,000$$

$$\text{Total} = \frac{14,400,000}{12} = 1,200,000$$

(Study Session 7, Module 23.5, LOS 23.h)

Question #25 of 170

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) 57,750.



B) 57,500.



C) 55,000.



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 = $1.05 \times 50,000 = 52,500$

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

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #26 of 170

Ajax Company's capital structure was as follows:

	December 31, 2004	December 31, 2003
<i>Outstanding shares of stock:</i>		
<i>Common</i>	200,000	200,000
<i>Convertible preferred</i>	5,000	5,000
<i>6% Convertible Bonds</i>	\$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:

	<u>Basic EPS</u>	<u>Diluted EPS</u>
A) \$1.95	\$1.95	
B) \$1.95	\$1.86	
C) \$1.80	\$1.86	



Explanation

Basic EPS: $[400,000 - 10,000] / 200,000 \text{ shares} = \1.95 per share

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #27 of 170

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.

(Study Session 7, Module 23.5, LOS 23.h)

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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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #29 of 170

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 increased.
- B) year-end market price of Zachary increased.
- C) average market price of Zachary decreased.



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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #30 of 170

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) net income.
- C) revenue.



Explanation

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

(Study Session 7, Module 23.6, LOS 23.j)

Question #31 of 170

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) 10,416,667.



B) 14,583,333.



C) 25,000,000.



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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #32 of 170

A complex capital structure would typically contain:

A) bank notes.



B) variable rate notes.



C) convertible bonds.



Explanation

A *complex capital structure* is one that contains 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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #33 of 170

When calculating earnings per share (EPS) for firms with complex capital structures, stock options are ordinarily considered to be:

A) antidilutive securities.



B) potentially dilutive securities.



C) derivative securities.



Explanation

Dilutive securities are securities that decrease EPS if they are exercised or converted to common stock. When the exercise price is less than the average market price, stock options are considered to be dilutive. Stock options, warrants, convertible debt, and convertible preferred stock are examples of potentially dilutive securities.

(Study Session 7, Module 23.5, LOS 23.i)

Question #34 of 170

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 $(1,000,000 \times \$42 / \$56)$ or 750,000 shares.

(Study Session 7, Module 23.5, LOS 23.i)

Question #35 of 170

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) \$3.37.
- C) \$3.12.



Explanation

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

Step 1: Calculate Adjusted EAC

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

$$\text{preferred dividends} = \text{convertible preferred dividends} = (0.08)(90)(500) = 3,600$$

$$\text{convertible debt interest} = (60,000)(0.06)(1 - 0.40) = 2,160$$

$$\text{adjusted EAC} = (30,000 - 3,600 + 3,600 + 2,160) = \$32,160$$

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)	=	<u>6,600</u>
<i>weighted ave. plus potential common shares outst.</i>			=	13,600

Step 3: Calculate Diluted EPS

$$\text{Diluted EPS} = 32,160 / 13,600 = \$2.36.$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #36 of 170

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) 105,000.



C) 104,000.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #37 of 170

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?

	<u>Basic Shares</u>	<u>Diluted Shares</u>
--	---------------------	-----------------------

A) 132,000

146,000



B) 130,000

132,000



C) 132,000

139,000



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:

$$110,000 \text{ shares} \times 12 \text{ months} = 1,320,000$$

$$\underline{33,000 \text{ shares} \times 8 \text{ months} = 264,000}$$

$$\text{Total share-month} = 1,584,000$$

$$\text{Average shares} = (1,584,000 / 12) = 132,000$$

Calculating diluted shares:

$$(1,000 \text{ bonds}) \times (21 \text{ shares each}) \times (4 \text{ months}) = 84,000 \text{ total share-month}$$

$$84,000 / 12 = 7,000 \text{ Average shares}$$

$$\text{Total diluted shares} = 7,000 \text{ (from convertible bonds)} + 132,000 \text{ (from stock)} = 139,000$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #38 of 170

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) nonoperating expenses are increasing.



B) operating 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.

(Study Session 7, Module 23.6, LOS 23.k)

Question #39 of 170

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

	<u>Dividends paid</u>	<u>Foreign currency translation gains and losses</u>	
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.

(Study Session 7, Module 23.6, LOS 23.m)

Question #40 of 170

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

- | | |
|---------------------------|---|
| A) invoices are billed. |  |
| B) expenses are incurred. |  |
| C) cash is collected. |  |

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.

(Study Session 7, Module 23.4, LOS 23.e)

Question #41 of 170

An analyst has gathered the following data pertaining to Hegel Company's construction projects, which began during 20X2:

	<u>Project 1</u>	<u>Project 2</u>
Contract price	\$420,000	\$300,000
Costs incurred in 20X2	240,000	280,000
Estimated costs to complete	120,000	40,000
Billed to customers during 20X2	150,000	270,000
Received from customers during 20X2	90,000	250,000

If Hengel used the completed contract method, what amount of gross profit (loss) would Hengel report in its 20X2 income statement for:

	<u>Project 1</u>	<u>Project 2</u>	
A) (\$20,000)	\$0		✗
B) \$0	(\$20,000)		✓
C) \$0	\$0		✗

Explanation

No profit is recognized until the completion of the project; however, expected losses are recognized. Project 2 has an expected loss of \$20,000.

(Study Session 7, Module 23.3, LOS 23.b)

Question #42 of 170

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) \$2.04. ✓
- B) \$1.94. ✗
- C) \$2.14. ✗

Explanation

Lawson's basic EPS ((net income – preferred dividends) / weighted average common shares outstanding) is $(\$1,060,000 - (2,000 \times \$1,000 \times 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 .

(Study Session 7, Module 23.5, LOS 23.h)

Question #43 of 170

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(\text{NI}) - \$1,000,000(\text{preferred dividends})] / 52,500,000 \text{ shares} = \$24,000,000 / 52,500,000 = \0.457

(Study Session 7, Module 23.5, LOS 23.h)

Question #44 of 170

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)?

<u>Basic EPS</u>	<u>Diluted EPS</u>
------------------	--------------------

A) \$1.00	\$0.80
-----------	--------



B) \$1.50	\$1.25
-----------	--------



C) \$1.00	\$1.25
-----------	--------



Explanation

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

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #45 of 170

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 non-convertible preferred stock dividends.



B) adjusted by adding back 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #46 of 170

An oil exploration company has been contracted to dig 100 exploratory holes for \$200,000. The cost to complete this job is estimated to be \$150,000, but the company doesn't recognize any of the \$50,000 profit until the job is completed. Which revenue recognition method is being used?

A) Completed contract method.



B) Percentage-of-completion method.



C) Cost recovery method.



Explanation

The completed contract method doesn't recognize revenue and expense until the contract is completed. The percentage-of-completion method would have recognized a portion of the \$50,000 profit prior to completion.

(Study Session 7, Module 23.3, LOS 23.b)

Question #47 of 170

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) \$2.75.



B) \$2.00.



C) \$3.75.



Explanation

Basic EPS = $(\$120,000 - 40,000 - 5,000) / 20,000 \text{ shares} = \3.75 .

(Study Session 7, Module 23.5, LOS 23.h)

Question #48 of 170

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) \$5.00.



B) \$5.80.



C) \$6.00.



Explanation

If bonds are converted, then net income will increase by 480,000 [$10 \text{ million} \times 0.08 \times (1 - 0.4)$] and shares outstanding will increase by 200,000.

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

denominator = $350,000 + (150,000 \times 4/12) + 200,000 = 600,000$

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #49 of 170

Converged accounting standards issued in May 2014 addressed:

A) revenue recognition.



B) inventory valuation.



C) depreciation of tangible assets.




Explanation

The converged accounting standards issued by IASB and FASB in May 2014 concern revenue recognition.

(Study Session 7, Module 23.3, LOS 23.d)

Question #50 of 170

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) selectively from among all units for sale. 
- C) in the same order the units are produced. 

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.




(Study Session 7, Module 23.4, LOS 23.e)

Question #51 of 170

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.

	<u>Net income</u>	<u>Comprehensive income</u>	
A) \$41,000	\$43,000		
B) \$40,000	\$43,000		
C) \$41,000	\$2,000		

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.

(Study Session 7, Module 23.6, LOS 23.I)

Question #52 of 170

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) 475,000.



C) 484,000.



Explanation

$[400,000 \text{ shares} \times 12 \text{ months} + 40,000 \times 12 \text{ months} + 90,000 \times 6 \text{ months} - (12,000 \times 1 \text{ months})]$ divided by 12 = 484,000 shares.

(Study Session 7, Module 23.5, LOS 23.h)

Question #53 of 170

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) \$7.50 / share.



B) \$5.00 / share.



C) \$10.50 / share.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #54 of 170

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.

(Study Session 7, Module 23.6, LOS 23.k)

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) \$1.94.

B) \$1.66.

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
			<i>Total</i>	<i>42.050</i>

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

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

(Study Session 7, Module 23.5, LOS 23.h)

Which of the following statements regarding basic and diluted earnings per share (EPS) is *most* accurate?

- A) If diluted EPS is less than basic EPS then the convertible securities are said to be antidilutive. ✗
- B) Diluted EPS does not include antidilutive securities in its computation. ✓
- C) To calculate diluted EPS, use net income less preferred dividends in the numerator. ✗

Explanation

To calculate diluted EPS, dividends on convertible preferred stock and the after tax interest on convertible debt need to be *added* to net income in the numerator. If diluted EPS are *more* than basic EPS, the convertible securities are antidilutive and should not be used in computing diluted EPS.

(Study Session 7, Module 23.5, LOS 23.i)

Question #57 of 170

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.

(Study Session 7, Module 23.1, LOS 23.a)

Question #58 of 170

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?

- | | <u>Balance sheet</u> | <u>Unrealized gains and losses</u> | |
|----|----------------------|------------------------------------|--------------------------------------|
| A) | Fair value | Net income | ✗ |
| B) | Fair value | Other comprehensive income | ✓ |
| C) | Amortized cost | 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.

(Study Session 7, Module 23.6, LOS 23.m)

Question #59 of 170

An airplane manufacturing company routinely builds fighter jets for the U.S. armed forces. It takes fourteen months to build one jet, and the government pays for them in installments over the fourteen-month period. Which revenue recognition method should be used?

A) Completed contract method.



B) Installment sales method.



C) Percentage-of-completion method.



Explanation

The percentage-of-completion method is appropriate in this case because payment is assured when dealing with the U.S. government, and cost and price estimates are assumed reliable due to the ongoing and routine nature of the contract.

(Study Session 7, Module 23.3, LOS 23.b)

Question #60 of 170

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

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



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



C) added to earnings available to common shareholders.



Explanation

Formula = Diluted EPS = $\frac{[(\text{Net income} - \text{Preferred dividends}) + \text{Convertible preferred dividends} + (\text{Convertible debt interest})(1 - t)]}{[(\text{Weighted average shares}) + (\text{Shares from conversion of conv. pfd shares}) + (\text{Shares from conversion of conv. debt}) + (\text{Shares issuable from stock options})]}$

(Study Session 7, Module 23.5, LOS 23.i)

Question #61 of 170

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

$1/1/00 \text{ 22,000 shares (adjusted for 10\% stock dividend)} \times 12 \text{ months} = 264,000$

$6/1/00 \text{ 7,700 shares (adjusted for 10\% stock dividend)} \times 7 \text{ months} = \underline{53,900}$

Total share month = 317,900

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


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


(Study Session 7, Module 23.5, LOS 23.h)

Question #62 of 170

Guidance from the U.S. Securities and Exchange Commission regarding the criteria for revenue recognition *least likely* specifies that there must be:

A) reasonable assurance that the product will be delivered or the service will be rendered. 

B) evidence of an arrangement between the buyer and the seller. 

C) a determined or determinable price. 

Explanation

One of the SEC's criteria for revenue recognition is that the product has been delivered or the service has been rendered. The other criteria are evidence of an arrangement between the buyer and seller; the price has been determined or is determinable; and the seller is reasonably assured of collecting money.

(Study Session 7, Module 23.3, LOS 23.b)

Question #63 of 170

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?

<u>Interest added to</u> <u>the numerator</u>	<u>Shares added to</u> <u>the denominator</u>
--	--

A) \$1,800 4,500 

B) \$3,000 18,000 

C) \$3,000 4,500 

Explanation

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #64 of 170

For an organization with a simple capital structure, the computation of earnings per share is *least likely* to consider:

A) the weighted average number of common shares outstanding.



B) net income.



C) the weighted average number of preferred shares outstanding.



Explanation

The equation for Basic EPS (net income – preferred dividends / weighted average number of common shares outstanding) does not include the number of preferred shares outstanding, because the objective is to determine the earnings available to the common shareholder.

(Study Session 7, Module 23.5, LOS 23.h)

Question #65 of 170

Under U.S. GAAP, when an unreliable estimate of costs exists and ultimate payment is assured, which of the following revenue recognition methods should be used?

A) Percentage-of-completion method.



B) Cost recovery method.



C) Completed contract method.



Explanation

The key word is "**unreliable**." The *completed contract method* is used under U.S. GAAP when cost estimates are unreliable. The *percentage-of-completion method* recognizes profit corresponding to the percentage of cost incurred to total estimated costs associated with long-term construction contracts. Percent-of-completion is used where contracts and cost estimates are **reliable**.

The *cost recovery method* is similar to the installment sales method but is more conservative. Sales are recognized when cash is received, but no gross profit is recognized until all of the cost of goods sold is collected.

(Study Session 7, Module 23.3, LOS 23.b)

Question #66 of 170

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.

	<u>Basic EPS</u>	<u>Diluted EPS</u>	
A) \$6.31	\$5.66		✗
B) \$7.45	\$6.26		✗
C) \$7.45	\$5.66		✓

Explanation

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

$$[850,00 - (3 \times 10,000)] / 110,000 = \$7.45$$

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)]

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #67 of 170

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) \$3.71. ✗
- C) \$5.32. ✗

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 $10,000 \times 10 \times \$40 = \$4,000,000$. 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 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #68 of 170

Under the general principles of accrual accounting, revenue is recognized when:

- A) earned, and expenses are recognized when incurred. 
- B) the good or service is delivered or cash is received, whichever is earlier. 
- C) cash is received, and expenses are recognized when cash is paid. 


Explanation

The principle of accrual accounting is that revenue is recognized when earned, and expenses are recognized when incurred.

(Study Session 7, Module 23.3, LOS 23.b)

Question #69 of 170

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) Both are nonoperating. 
- B) Both are operating. 
- C) Only one is 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.

(Study Session 7, Module 23.4, LOS 23.g)

Question #70 of 170

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) \$1.74.



B) \$2.44.



C) \$0.90.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #71 of 170

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) \$5.32.



B) \$5.87.



C) \$4.91.



Explanation

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

If the convertible preferred stock was converted to common stock at January 1, $(10,000 \times 20 =) 200,000$ 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 $(70,000 \times 10 \times \$50 =) \$35,000,000$. 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 / (1,100,000 + 135,484) =) \6.19 . 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 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #72 of 170

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) 20,266,667.

C) 20,783,333.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #73 of 170

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) Interest income.
- C) Income tax expense.



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.

(Study Session 7, Module 23.4, LOS 23.g)

Question #74 of 170

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 ($5.0 \times 3/2$) as a result of the 3:2 split.

(Study Session 7, Module 23.5, LOS 23.h)

Question #75 of 170

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) \$3.33.
- B) \$4.00.
- C) \$2.77.



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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #76 of 170

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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #77 of 170

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 \times \$1,000 \times 0.06) \times (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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #78 of 170

Information about a company's revenue recognition policies is *most likely* disclosed in:

- A) Management's Discussion and Analysis.
- B) the financial statement notes.
- C) the standard auditor's report.



Explanation

Revenue recognition policies are disclosed in the footnotes to the financial statements.

(Study Session 7, Module 23.3, LOS 23.b)

Question #79 of 170

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) \$3.00.



B) \$1.50.



C) \$1.33.



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 .

(Study Session 7, Module 23.5, LOS 23.h)

Question #80 of 170

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



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



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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #81 of 170

Which of the following is NOT a requirement for revenue recognition to occur?

A) Transactions giving rise to revenue should be arms-length. 

B) Earning activities are substantially completed. 

C) Cash must have been received. 

Explanation

Revenue from credit sales may be recognized when sales are on account.

Other conditions when revenues are also considered earned include when: revenue can be measured with reasonable accuracy, transactions are not subject to revocation, it is possible to measure the cost of provided goods (no significant contingent obligation), and there is assurance of payment (cash) or collectability.


(Study Session 7, Module 23.3, LOS 23.b)


Question #82 of 170


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) 41,550,000. 

B) 42,400,000. 

C) 20,780,000. 

Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #83 of 170

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) 210,000.



B) 140,000.



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, $(60,000 \times 6 / 12) = 30,000$ is added to that figure, for a total of 150,000.

(Study Session 7, Module 23.5, LOS 23.h)

Question #84 of 170

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) 105,500.



B) 101,000.



C) 98,000.



Explanation

Initial shares: $90,000 \times 1.20 =$	108,000
- Recquired treasury shares: $10,000 \times 3/12 =$	<u>-2,500</u>
	105,500

(Study Session 7, Module 23.5, LOS 23.h)

Question #85 of 170

The primary difference between basic EPS and diluted EPS is that:

- A) discontinued operations are omitted from basic EPS but included in diluted EPS. ✗
- B) proprietors and partners report basic EPS but corporations report diluted EPS. ✗
- C) diluted EPS includes the potential effects of convertible securities while basic EPS does not. ✓

Explanation

The primary difference between basic EPS and diluted EPS is that diluted EPS includes the potential effects of convertible securities while basic EPS does not.

(Study Session 7, Module 23.5, LOS 23.i)

Question #86 of 170

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) 201,666. ✗
- B) 220,000. ✓
- C) 211,111. ✗

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 = $100,000 \times 2 \times 1.1 = 220,000$.

(Study Session 7, Module 23.5, LOS 23.h)

Question #87 of 170

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

- A) 3%, \$100 par value convertible preferred.
- B) 7%, \$100 par value non convertible preferred.
- C) 6%, \$5000 par value putable bond.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #88 of 170

Which of the following statements regarding the methods of revenue recognition is *most* accurate? In the first year of a long-term contract:

- A) the completed contract method, in comparison to the percentage-of-completion method, will generally result in higher net income.
- B) the percentage-of-completion method generally results in lower retained earnings than the completed contract method.
- C) the completed contract method is used when the selling price or cost estimates are unreliable.



Explanation

The completed contract method compared to the percentage-of-completion method will result in lower net income in the first year because revenue and profit are recognized later. Hence, retained earnings will also be lower than the percentage-of-completion method.

(Study Session 7, Module 23.3, LOS 23.b)

Question #89 of 170

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

- A) Either decrease or increase EPS depending upon if the security is dilutive or antidilutive.
- B) Increase EPS.
- C) Decrease EPS.



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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #90 of 170

In its first year of business, Digmore Corporation's balance sheet shows gross fixed assets at \$90 million and accumulated depreciation of \$10 million. If the estimated salvage value of these assets is \$10 million, and the original estimated useful life is 8 years, what method of depreciation did Digmore *most likely* use?

A) Double-declining-balance.



B) Straight Line.



C) Units of production.



Explanation

$\$90 - \$10 \text{ million} = \$80 \text{ million}$; $\$80 \text{ million} / 8 = \10 million depreciation per year under Straight Line depreciation.

(Study Session 7, Module 23.4, LOS 23.e)

Question #91 of 170

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) 325.



B) 714.



C) 1,039.



Explanation

$(1,039 \text{ options})(\$11) = \$11,429$

$\$11,429 / \16 per share

$1039 - 714 = 325 \text{ shares}$ or $[(16 - 11) / 16]1,039 = 325$.

(Study Session 7, Module 23.5, LOS 23.i)

Question #92 of 170

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) 1,666,667.



B) 1,440,000.



C) 1,500,000.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #93 of 170

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) \$0.261.



B) \$0.289.



C) \$0.197.



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 $700,000 + (200,000 \times 10 / 12) = 866,667$. Basic EPS was $\$330,000 - (2,000 \times \$500 \times 0.08) / 866,667 = \0.289 .

If the convertible preferred shares were converted to common stock, $2,000 \times 200 = 400,000$ 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 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #94 of 170

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) 870,000.



B) 930,000.



C) 735,000.



Explanation

The January 1 balance is adjusted retroactively for the stock dividend and $(540,000 \times 1.5) = 810,000$ 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	$(810,000 \times 12) =$	9,720,000
July 1	Reacquired shares	$(-180,000 \times 6) =$	1,080,000
October 1	Reissued shares	$(60,000 \times 3) =$	<u>180,000</u>
			8,820,000

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #95 of 170

The calculation of the income recognized in the third year of a five-year construction contract accounted for using the percentage-of-completion method begins with the ratio of:

A) costs incurred in year 3 to total billings.



B) total costs incurred to total estimated cost.



C) costs incurred in year 3 to total estimated costs.



Explanation

The percentage of completion method recognizes revenues in proportion to the percentage of expenses incurred. Using only the current year's costs produces an incorrect result if the estimated total cost has changed. Revenue recognized in any given year is costs to date divided by total estimated costs, times total estimated revenue for the project, minus revenue that has already been recognized.

(Study Session 7, Module 23.3, LOS 23.b)

Question #96 of 170

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) interest expense per dollar of sales declined.



B) the effective tax rate increased.



C) cost of goods sold 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.

(Study Session 7, Module 23.6, LOS 23.k)

Question #97 of 170

According to the converged standards for revenue recognition issued in May 2014, a promise to transfer a distinct good or service is *most accurately* described as a:

A) contract.



B) performance obligation.



C) transaction.



Explanation

In the converged accounting standards issued in May 2014, performance obligations within a contract are defined as promises to transfer distinct goods or services.

(Study Session 7, Module 23.3, LOS 23.d)

Question #98 of 170

The Kammel 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, Kammel had costs of \$30 million. Kammel's reported profit for the first year of the contract, using the completed contract method, is:

- A) \$15 million.
- B) \$10 million.
- C) \$0.



Explanation

Under the completed contract method, profit is only reported upon completion of the contract.

(Study Session 7, Module 23.2, LOS 23.c)

Question #99 of 170

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

- A) straight capital structure.
- B) non-diluted capital structure.
- C) simple 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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #100 of 170

An analyst has gathered the following information about Barnstabus, 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.
- Barnstabus, has \$60,000 of 6.0% convertible bonds outstanding, with each of the 60 bonds convertible into 110 shares of Barnstabus common stock.

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

- A) \$2.36.
- B) \$1.66.
- C) \$1.53.



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
	<u>after-tax</u>
+	<u>interest on</u>
	<u>convertible</u>
	<u>debt</u>
	adjusted earnings available for common shares
=	

$$\text{preferred dividends} = (0.08)(90)(2,000) = 14,400$$

$$\text{convertible debt interest} = (60,000)(0.06)(1 - 0.40) = 2,160$$

$$\text{adjusted EAC} = (30,000 - 14,400 + 2,160) = \mathbf{\$17,760}$$

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

weighted average common shares	=	5,000
shares from conversion of convertible bonds	$= (60 \times 110)$	<u>6,600</u>
weighted ave. plus potential common shares outst.	=	11,600


Step 3: Calculate Diluted EPS

$$\text{Diluted EPS} = 17,760 / 11,600 = \mathbf{\$1.53}.$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #101 of 170

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

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

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) The general rule is retrospective application.



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.

(Study Session 7, Module 23.4, LOS 23.f)

Question #102 of 170

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) 39,500.



B) 37,000.



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:

$$\text{Adjusted shares} = 1.05 \times 20,000 = 21,000$$

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

$$\text{Adjusted beginning-of-year shares} = 42,000 (= 2 \times 21,000)$$

$$\text{Adjusted repurchase} = 10,000 (= 2 \times 5,000)$$

Step 3) Compute the weighted average number of shares.

$$42,000(12/12) - 10,000(6/12) = 37,000 \text{ shares}$$

(Study Session 7, Module 23.5, LOS 23.h)

Question #103 of 170

When a reliable estimate of costs exists, ultimate payment is assured, and revenue is earned as costs are incurred, which of the following revenue recognition methods should be used?

A) Cost recovery method.



B) Percentage-of-completion method.



C) Installment sales method.



Explanation

The *installment sales method* recognizes revenue and associated cost of goods sold only when cash is received. Gross profit (sales – cost of goods sold) reflects the proportion of cash received.

The *cost recovery method* is similar to the installment sales method but is more conservative. Sales are recognized when cash is received, but no gross profit is recognized until all of the cost of goods sold is collected.

(Study Session 7, Module 23.3, LOS 23.b)

Question #104 of 170

In accounting for long-term construction contracts, the percentage-of-completion method is preferable to the completed contract method when:

A) lack of dependable cost estimates cause forecasts to be doubtful.



B) estimates of the costs to complete and the extent of progress toward completion are reasonably dependable.



C) the contracts are of a relatively short duration (less than one year).



Explanation

In accounting for long-term construction contracts, the percentage-of-completion method is preferable to the completed contract method when estimates of the costs to complete and the extent of progress toward completion are reasonably dependable.

(Study Session 7, Module 23.3, LOS 23.b)

Question #105 of 170

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.

	<u>Basic EPS</u>	<u>Diluted EPS</u>	
A)	\$1.19	\$1.22	
B)	\$1.22	\$1.22	
C)	\$1.19	\$1.18	

Explanation

2004 Basic EPS:

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

2004 Diluted EPS:

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #106 of 170

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) \$5.45.
- B) \$5.60.
- C) \$4.94.



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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #107 of 170

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) \$3.00.



C) \$2.00.



Explanation

Interest is already deducted from earnings.

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #108 of 170

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) \$3.28.



B) \$2.96.



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: $\$372,000 + ((\$1,000 \times 2,000 \times 0.06) \times (1 - 0.40)) = \$444,000$.

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #109 of 170

Which revenue recognition method is used when the payment is assured and revenue is earned as costs are incurred?

A) Percentage-of-completion method.



B) Cost recovery method.



C) Installment sales method.



Explanation

The installment sales method is used when the assurance of payment and estimated bad debts does not exist before cash is collected. Sales revenue and COGS are recognized only when cash is received.

The cost recovery method is used when future cash collections are not assured even after receipt of partial payments. Gross profit is not recognized until all of the cost of goods sold is collected.

(Study Session 7, Module 23.3, LOS 23.b)

Question #110 of 170

Examples of potentially dilutive securities include all of the following EXCEPT:

A) convertible preferred stock.



B) non-convertible bonds.



C) options.



Explanation

Preferred stock and bonds are only considered to be potentially dilutive if they are convertible. Options are always considered to be potentially dilutive.

(Study Session 7, Module 23.5, LOS 23.i)

Question #111 of 170

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?

<u>Consumer loans</u>	<u>Investment securities</u>
-----------------------	------------------------------

A) Operating Nonoperating



B) Operating Operating



C) Nonoperating Operating






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.

(Study Session 7, Module 23.4, LOS 23.g)

Question #112 of 170

According to the installment method of accounting, gross profit on an installment sale is recognized:

- A) in proportion to the cash collection. 
- B) on the date the final cash collection is received. 
- C) after cash collections equal to the cost of sales have been received. 

Explanation

The installment sales method recognizes sales and COGS in proportion to cash collections.




(Study Session 7, Module 23.3, LOS 23.b)

Question #113 of 170

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) 2.5 million. 
- B) 1.9 million. 
- C) 1.6 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 ($= 200,000 \times 9/12$), plus 250,000 shares for the end-of-June issue ($= 500,000 \times 6/12$), plus 200,000 shares for the end-of-September issue ($= 800,000 \times 3/12$), or 1.6 million shares.

(Study Session 7, Module 23.5, LOS 23.h)

Question #114 of 170

Cash collection is a critical event for income recognition under the:

	<u>Cost-Recovery Method</u>	<u>Installment Method</u>	
A) Yes	No		✗
B) Yes	Yes		✓
C) No	Yes		✗

Explanation

Recognition of income depends on cash collected under both methods.

(Study Session 7, Module 23.3, LOS 23.b)

Question #115 of 170

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) Net income 65% ✗
- C) Income tax expense 54% ✗

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%

(Study Session 7, Module 23.6, LOS 23.j)

Question #116 of 170

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

- A) callable preferred stock.
- B) convertible bonds.
- C) treasury stock.



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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #117 of 170

Under the cost recovery method, profit is recognized:

- A) as collection occurs.
- B) at time of delivery.
- C) after the amount of cost has been collected.



Explanation

The cost recovery method is used when the costs to provide goods or services are not known. Under this method, sales are recognized when cash is received, but no gross profit is recognized until all of the cost of goods sold is collected.

(Study Session 7, Module 23.3, LOS 23.b)

Question #118 of 170

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?

- | | <u>Revenue</u> | <u>Income</u> |
|----------------|----------------|---------------|
| A) \$1,076,923 | \$376,923 | |
| B) \$1,000,000 | \$0 | |
| C) \$923,077 | -\$76,923 | |



Explanation

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

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 = $923,077 - 1,000,000 = \$-76,923$

(Study Session 7, Module 23.2, LOS 23.c)

Question #119 of 170

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) 197,500.



B) 250,000.



C) 167,500.



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	$160,000 \times 12 =$	1,920,000
July 1: Smith acquisition	$60,000 \times 6 =$	360,000
October 1: cash issuance	$30,000 \times 3 =$	<u>90,000</u>
Total:		2,370,000

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #120 of 170

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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #121 of 170

When evaluating the differences between two revenue recognition policies, an analyst should view the policy as more conservative which:

A) is more dependent on management estimates.



B) results in less leverage on the balance sheet.



C) recognizes revenue later.



Explanation

Recognizing revenue later rather than sooner is considered more conservative. More aggressive (less conservative) revenue recognition can result in less leverage by increasing assets.

(Study Session 7, Module 23.3, LOS 23.b)

Question #122 of 170

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

A) estimates and are applied retrospectively.



B) principle 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.

(Study Session 7, Module 23.4, LOS 23.f)

Question #123 of 170

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?

<u>Retained earnings</u>	<u>Total stockholders' equity</u>
--------------------------	-----------------------------------

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.

(Study Session 7, Module 23.6, LOS 23.I)

Question #124 of 170

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) 321.



B) 481.



C) 802.



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:

$$802 - 481 = 321$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #125 of 170

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) 5,000.



C) 4,500.



Explanation

$1/1 \text{ } 5,500 \text{ shares issued (includes 10\% stock dividend on 6/1)} \times 12 = 66,000$

$7/1 \text{ } 1,000 \text{ shares repurchased} \times 6 \text{ months} = 6,000$

$66,000 - 6,000 = 60,000 \text{ shares}$

$60,000 \text{ shares} / 12 \text{ months} = 5,000 \text{ average shares}$

(Study Session 7, Module 23.5, LOS 23.h)

Question #126 of 170

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

$(1,200 \times \$1,000 \times 12/20) = \$720,000$

(Study Session 7, Module 23.3, LOS 23.c)

Question #127 of 170

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) Yes

No



B) Yes

Yes



C) No

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.

(Study Session 7, Module 23.1, LOS 23.a)

Question #128 of 170

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 .

(Study Session 7, Module 23.2, LOS 23.c)

Question #129 of 170

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) \$0.165.



C) \$0.15.



Explanation

Caledonia's basic EPS = $(\text{net income} - \text{preferred stock dividends}) / (\text{weighted average common shares outstanding})$

$$= [\$460,000 - (\$1,000 \times 1,000 \times 0.08)] / 2,300,000 = \$0.17.$$

Using the treasury stock method, if the warrants were exercised, cash inflow would be $10,000 \times 100 \times \$1.50 = \$1,500,000$. 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 $1,000,000 - 750,000 = 250,000$.

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #130 of 170

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) 1,000,000.



B) 1,100,000.



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) = $(10,000) \times (100) \times (0.06) \times (0.6) \times (0.5) = 18,000$, so the numerator = 1,518,000 **Denominator impact:** increase in average shares = $[(\# \text{ bonds}) \times (\text{conversion factor}) \times (\# \text{ months outstanding})] / 12 = (1,200,000 / 12 = 100,000)$ 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #131 of 170

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) \$1.00.



B) \$0.33.



C) \$0.50.



Explanation

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

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

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #132 of 170

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

- A) assumes that the hypothetical funds received by the company from the exercise of the options are used to sell shares of the company's common stock in the market at the average market price ✓
- B) is used when the exercise price of the option is less than the average market price. ✗
- C) increases the total number of shares by less than the number that the exercise of the options would create. ✗

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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #133 of 170

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.

$$\text{Basic EPS} = (\text{net income} - \text{preferred dividends}) / \text{weighted average common shares outstanding} = (9.0 - 1.5) / 5.0 = \$1.50.$$

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 = $\# \text{ options} - [(\# \text{ options} \times \text{exercise price}) / \text{average stock price}] = 400,000 - [(400,000 \times 32) / 35] = 34,286$ 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 = $(\# \text{ preferred shares} \times \text{conversion rate}) = 500,000 \times 5 = 2,500,000$, or 2.5 million. Then, $\text{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 $(\text{face value} \times \text{coupon} \times (1 - t))$, or $(10,000 \text{ bonds} \times 1,000 \text{ par} \times 0.06 \text{ coupon} \times 0.6) = 360,000$, or \$0.360 million. The denominator impact = $(\# \text{ convertible bonds} \times \text{conversion rate}) = 10,000 \times 8 = 80,000$, or 0.080 million. Then, $\text{EPS} = (9.0 - 1.5 + 0.360) / (5.0 + 0.080) = \1.55 . Thus the bonds are antidilutive.

Finally, calculate diluted EPS:

$$\text{Diluted EPS} = (9.0 - 1.5 + 1.5) / (5.0 + 2.5 + 0.034) = \$1.1946.$$

(Study Session 7, Module 23.5, LOS 23.h)

Question #134 of 170

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:

	<u>Basic EPS</u>	<u>Diluted EPS</u>	
A) \$65.63	\$48.00		✗
B) \$55.00	\$48.00		✓
C) \$55.00	\$51.56		✗

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 \times \$1,000 \times 0.09)(1 - .40)] / (300,000 + (50,000 \times 2)) = \48.00 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #135 of 170

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

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

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



C) Basic EPS can be less than diluted EPS.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #136 of 170

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) Only one should be recognized.



B) Both should be recognized.



C) Neither 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.

(Study Session 7, Module 23.1, LOS 23.a)

Question #137 of 170

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) \$1.00.



B) \$0.98.



C) \$0.99.



Explanation

Use the Treasury stock method

$$\text{Proceeds} = 100,000 (\$40) = \$4,000,000$$

$$\text{Shares assumed purchased with proceeds} = \$4,000,000 / \$50 = 80,000 \text{ shares}$$

$$\text{Potential dilution} = 100,000 - 80,000 = 20,000 \text{ shares}$$

$$\text{Basic EPS} = \$1/\text{share}$$

$$\text{Diluted EPS} = \$1,000,000 / 1,020,000 = \$0.98/\text{share}$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #138 of 170

When calculating earnings per share (EPS) for firms with complex capital structures, convertible preferred stock is ordinarily considered to be a:

A) potentially dilutive security.



B) non-equity security.



C) antidilutive security.



Explanation

Dilutive securities are securities that decrease EPS if they are exercised or converted to common stock. Stock options, warrants, convertible debt, and convertible preferred stock are examples of potentially dilutive securities. Note that if diluted EPS when considering the convertible preferred stock is greater than basic EPS, the convertible preferred stock would be antidilutive and should not be treated as common stock in computing diluted EPS.

(Study Session 7, Module 23.5, LOS 23.i)

Question #139 of 170

As a general rule, revenue is normally recognized when it is:

A) realizable and earned.



B) earned.



C) measurable.



Explanation

Under the accrual concept, revenue is recognized when the earnings process is completed (earned) and ultimate realization (cash receipt) is assured.

(Study Session 7, Module 23.3, LOS 23.b)

Question #140 of 170

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:

	<u>Basic EPS</u>	<u>Diluted EPS</u>	
A) \$5.19	\$4.92		✗
B) \$6.00	\$5.45		✓
C) \$6.00	\$4.92		✗

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 \times \$1,000 \times 0.08)(1 - 0.40)] / [800,000 + (5,000 \times 25)] = \5.45 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #141 of 170

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

- A) Effective tax rate. ✓
- B) Ratio of SG&A expense to sales. ✗
- C) Net profit margin. ✗

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.

(Study Session 7, Module 23.6, LOS 23.j)

Question #142 of 170

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?

	<u>Assets</u>	<u>Liabilities</u>	
A) Increase	No effect		✓
B) Increase	Increase		✗
C) No effect	Increase		✗

Explanation

When a firm recognizes revenue before cash is collected, equity increases (retained earnings) and assets increase (accounts receivable). Liabilities would not be affected.

(Study Session 7, Module 23.4, LOS 23.e)

Question #143 of 170

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) \$0.777.



B) \$0.782.



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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #144 of 170

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

<i>Supple Moves</i>	<i>Perfect Collection</i>
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) Perfect Collection only.



B) Supple Moves 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.)

(Study Session 7, Module 23.5, LOS 23.h)

Question #145 of 170

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) 999.



B) 231.



C) 768.



Explanation

$$(999)(10) = 9,990$$

$$9,990 / 13 = 768$$

$$999 - 768 = 231$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #146 of 170

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) \$1.00.



B) \$1.15.



C) \$2.50.



Explanation

Number of average common shares:

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

7/1 1,000 shares repurchased $\times 6$ 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 = $(1,000 \text{ preferred shares})(8 \times 1.1 \text{ shares of common/share of preferred}) = 8,800 \text{ common}$

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

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

Basic EPS = $[\$15,000(\text{NI}) - \$10,000(\text{preferred dividends})] / 5,000 \text{ shares} = \$5,000 / 5,000 \text{ shares} = \$1/\text{share}$

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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #147 of 170

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

Yes



B) No

No



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.

(Study Session 7, Module 23.6, LOS 23.I)

Question #148 of 170

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?

- | | <u>Accrued interest</u> | <u>Preferred dividends</u> | |
|--------|-------------------------|----------------------------|---|
| 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.

(Study Session 7, Module 23.4, LOS 23.g)

Question #149 of 170

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) \$1.15. |  |
| C) \$3.25. |  |

Explanation

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

(Study Session 7, Module 23.5, LOS 23.h)

Question #150 of 170

Football Contractors, Inc., which reports under U.S. GAAP, has contracted to build a stadium for the City of Washburn. The contract price is \$100 million and costs are estimated at \$60 million. Costs are not assured, however, because there is a material risk, which Football Contractors has assumed, that ground water problems might slow construction and increase costs by as much as \$40 million. In 2004, the first year of the agreement, Football Contractors, Inc. billed \$30 million, received a \$20 million payment, and incurred \$15 million in costs. For 2004 Football Contractors, Inc. should recognize revenue from the City of Washburn transaction in the amount of:

A) \$20 million.



B) \$0.00



C) \$30 million.



Explanation

Under U.S. GAAP, the completed contract method is used when a reliable estimate of the total costs cannot be determined until the contract is finished. Because of the significant uncertainty surrounding the ground water costs, the completed contract method should be used in this transaction, and no revenue should be recognized in 2004 or any later year until the contract is completed or the cost uncertainty is resolved.

(Study Session 7, Module 23.2, LOS 23.c)

Question #151 of 170

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) 8,433.



B) 9,986.



C) 2,689.



Explanation

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

$$9,986 \times \$38 = \$379,468$$

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




$$\$379,468 / \$52 = 7,297 \text{ common shares}$$

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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #152 of 170

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

- A) LIFO to average cost inventory valuation. 
- B) zero salvage value to positive salvage value. 
- C) percentage-of-completion to completed contract revenue recognition. 

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.




(Study Session 7, Module 23.4, LOS 23.f)

Question #153 of 170

JME Construction always uses the percentage of completion method of recognizing revenue. During 2004 JME signs a contract in the amount of \$10 million with the following data available:

Costs incurred to date	\$2,200,000
Billings to date	\$2,000,000
Cash collected	\$1,750,000
Total cost of project	\$8,800,000

How much gross profit should JME recognize for 2004?

- A) \$300,000. 
- B) -\$450,000. 
- C) -\$200,000. 

Explanation

stage of completion = $25\% (2.2 / 8.8)$




revenue to be recognized = $0.25 \times 10 \text{ million} = 2.5 \text{ million}$

gross profit = $2.5 \text{ million} - 2.2 \text{ million} = 300,000$

(Study Session 7, Module 23.3, LOS 23.b)

Question #154 of 170

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.

(Study Session 7, Module 23.5, LOS 23.h)

Question #155 of 170

When calculating earnings per share (EPS) for firms with complex capital structures, convertible bonds are ordinarily considered to be:

A) potentially dilutive securities.



B) antidilutive securities.



C) embedded debt securities.



Explanation

Dilutive securities are securities that decrease EPS if they are exercised or converted to common stock. Stock options, warrants, convertible debt, and convertible preferred stock are examples of potentially dilutive securities. Note that if diluted EPS when considering the convertible bonds is greater than basic EPS, the convertible bonds would be antidilutive and should not be treated as common stock in computing diluted EPS.

(Study Session 7, Module 23.5, LOS 23.i)

Question #156 of 170

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

A) rules-based.



B) objectives-based.



C) principles-based.



Explanation

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

(Study Session 7, Module 23.3, LOS 23.d)

Question #157 of 170

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 = $[(500,000 \times 12) + (200,000 \times 6) - (100,000 \times 3)] / 12 = 575,000$.
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 = $\$5,600,000 + [6,000 \times \$1,000 \times 0.05 \times (1 - 0.40)] = \$5,780,000$. Diluted EPS = $\$5,780,000 / (575,000 + 120,000) = \8.32 .

(Study Session 7, Module 23.5, LOS 23.i)

Question #158 of 170

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:

	<u>Basic EPS</u>	<u>Diluted EPS</u>
--	------------------	--------------------

A) \$0.64	\$0.64
-----------	--------



B) \$0.55	\$0.52
-----------	--------



C) \$0.55	\$0.55
-----------	--------



Explanation

Able's basic earnings per share ((Net Income – Preferred Stock Dividends) / weighted average shares outstanding) for 2004 was $[(\$720,000 - (\$500 \times 6,000 \times 0.03) - (\$1,000 \times 1,000 \times 0.08)) / 1,000,000 = \0.55 . If the convertible preferred were converted to common stock on January 1, $6,000 \times 40 = 240,000$ 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 .

(Study Session 7, Module 23.5, LOS 23.h)

Question #159 of 170

Securities that would decrease earnings per share (EPS) if they were exercised and converted to common stock are called:

A) synthetic securities.



B) antidilutive securities.



C) dilutive securities.



Explanation

Dilutive securities are securities that decrease EPS if they are exercised or converted to common stock. Stock options, warrants, convertible debt, and convertible preferred stock are examples of dilutive securities.

(Study Session 7, Module 23.5, LOS 23.i)

Question #160 of 170

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

A) warrants.



B) stock options.



C) preferred stock.



Explanation

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

(Study Session 7, Module 23.5, LOS 23.i)

Question #161 of 170

At the beginning of 2007, Thunderbird Company started a 3-year construction project. The following data relates to the project:

Contract price	\$100 million
Costs incurred in 2007	\$50 million
Progress billings	\$40 million
Collection of progress billings	\$37 million

Because of cost overruns, Thunderbird cannot reliably estimate the total cost of the project. However, Thunderbird expects that its costs incurred so far are recoverable. What amount of revenue should Thunderbird recognize for the year ended 2007 under U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS)?

	<u>U.S. GAAP</u>	<u>IFRS</u>	
A) \$0	\$50 million		✓
B) \$0	\$0		✗
C) \$37 million	\$40 million		✗

Explanation

The completed-contract method must be used under U.S. GAAP since Thunderbird cannot reliably estimate the project's cost. Under the completed-contract method, no revenue is recognized until the project is complete. Under IFRS, when total cost cannot be reliably estimated, revenue is recognized to the extent that recovering contract costs is probable. Since Thunderbird incurred \$50 million of cost in 2007, \$50 million of revenue is recognized.

(Study Session 7, Module 23.3, LOS 23.b)

Question #162 of 170

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) Both of these items are included in comprehensive income. ✓
- B) Neither of these items is included in comprehensive income. ✗
- C) Only one of these items is 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).

(Study Session 7, Module 23.6, LOS 23.I)

Question #163 of 170

Which, if any, of the following statements about the installment sales method and cost recovery method is correct?

Statement 1: The cost recovery method recognizes revenue and associated costs of goods sold only when cash is received, based on gross profit margin.

Statement 2: The installment sales method recognizes sales when cash is received, but no gross profit is recognized until all of the cost of goods sold is collected.

A) Both statements are correct.



B) Neither statement is correct.



C) Only one of these statements is correct.



Explanation

Neither statement is correct because the definitions are reversed.

(Study Session 7, Module 23.3, LOS 23.b)

Question #164 of 170

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)	\$3.30	\$2.00	
B)	\$4.00	\$2.86	
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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #165 of 170

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) \$123.02.



B) \$159.13.



C) \$117.75.



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 = $[(115,000 \times 12) + (60,000 \times 9) - (45,000 \times 3)] / 12 = 148,750$. Basic EPS = $\$18,300,000 / 148,750 = \123.02 .

Using the treasury stock method, if the warrants were exercised cash inflow would be $200 \times \$100 \times 100 = \$2,000,000$. 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.

(Study Session 7, Module 23.5, LOS 23.i)

Question #166 of 170

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) \$1.20.



B) \$2.50.



C) \$1.00.



Explanation

Number of average shares:

$$1/1 \text{ 5,500 shares issued (includes 10\% stock dividend on 6/1)} \times 12 = 66,000$$

$$7/1 \text{ 1,000 shares repurchased} \times 6 \text{ months} = 6,000$$

$$66,000 - 6,000 = 60,000$$

$$60,000 \text{ shares} / 12 \text{ months} = 5,000 \text{ average shares}$$

$$\text{Preferred dividends} = (\$10)(\$1,000) = \$10,000$$

$$\text{Basic EPS} = [\$15,000(\text{NI}) - \$10,000(\text{preferred dividends})] / 5,000 \text{ shares} = \$5,000 / 5,000 \text{ shares} = \$1/\text{share}$$

(Study Session 7, Module 23.5, LOS 23.h)

Question #167 of 170

Under U.S. GAAP, if a reliable estimate of total costs of a long-term contract does not exist, which of the following revenue recognition methods should be used?

A) Completed contract method.



B) Cost recovery method.



C) Percentage-of-completion method.



Explanation

The percentage-of-completion method is used when ultimate payment is assured and revenue is earned as costs are incurred. Profit is recognized corresponding to the percentage of costs incurred to the total estimated.

If the total cost of a long-term contract cannot be estimated reliably, U.S. GAAP requires the completed contract method to be used for revenue recognition. The cost recovery method is used for installment sales when future cash collections are not assured.

(Study Session 7, Module 23.3, LOS 23.b)

Question #168 of 170

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) 992.



C) 744.



Explanation

$$(992)(\$9) = \$8928$$




$$\$8928 / 12 = 744$$

$$992 - 744 = 248 \text{ new shares or } [(12 - 9) / 12]992 = 248$$

(Study Session 7, Module 23.5, LOS 23.i)

Question #169 of 170

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

- A) Use accelerated amortization for tax reporting and straight-line amortization for financial reporting. 
- B) Use straight-line amortization. 
- C) Test for impairment but do not amortize. 

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.

(Study Session 7, Module 23.4, LOS 23.e)

Question #170 of 170

For the year ended December 31, 2007, 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
Increase in minimum 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-sale-securities	20,000

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

- | | <u>Net income</u> | <u>Comprehensive income</u> |
|--------------|-------------------|-----------------------------|
| A) \$40,000 | \$44,000 | |
| B) \$490,000 | \$2,000 | |
| C) \$490,000 | \$435,000 | |



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 increase in minimum 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.

(Study Session 7, Module 23.6, LOS 23.I)

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