Understanding Income Statements 01

Test ID: 7694036

Question #1 of 90

Question ID: 414186

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

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

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

✗ **A) $1.66.**

✓ **B)** $1.53.

✗ **C)** $2.36.

Explanation

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

Step 1: *Calculate Adjusted EAC*

> *adjusted EAC*: net income - preferred dividends
>
> + after-tax interest on convertible debt
>
> = adjusted earnings available for common shares
>
> *preferred dividends* = (0.08)(90)(2,000) = 14,400
>
> convertible debt interest = (60,000)(0.06)(1 - 0.40) = 2,160
>
> adjusted EAC = (30,000 - 14,400 + 2,160) = $17,760

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

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

Step 3: *Calculate Diluted EPS*

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

Question #2 of 90

Question ID: 414123

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) $10.50 / share.**

✗ **B)** $7.50 / share.

✓ **C)** $5.00 / share.

Explanation

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

Question #3 of 90

Question ID: 414121

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) $2.25.**

✓ **B)** $4.75.

✗ **C)** $2.50.

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.

Question #4 of 90

Question ID: 414154

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

✗ **A) net income.**

✓ **B)** the weighted average number of preferred shares outstanding.

✗ **C)** the weighted average number of common 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.

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Question ID: 414088

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) $1,200,000.**

✓ **B)** $720,000.

✗ **C)** $960,000.

Explanation

(1,200 × $1,000 × 12/20) = $720,000

Question #6 of 90

Question ID: 414134

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

✗ **A) 14,583,333.**

✗ **B)** 10,416,667.

✓ **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.

Question #7 of 90

Question ID: 414075

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)** Completed contract method.

✗ **C)** Cost recovery 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.

Question #8 of 90

Question ID: 414176

Rushford Corp.'s net income is $16,500,000 with 300,000 shares outstanding. The tax rate is 40%. The average share price for the year was $372. Rushford has 50,000, 9%, $1,000 par value convertible bonds outstanding. Each bond is convertible into two shares of common stock.
Rushford Corp.'s basic and diluted earnings per share (EPS) are *closest* to:

	Basic EPS	Dilutied EPS
✗ **A)**	**$55.00**	**$51.56**

✓ **B)** $55.00 $48.00

✗ **C)** $65.63 $48.00

Explanation

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

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Question ID: 414143

A complex capital structure would typically contain:

✗ **A) bank notes.**

✓ **B)** convertible bonds.

✗ **C)** variable rate notes.

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.

Question #10 of 90

Question ID: 414180

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 2005 but not in 2004.**

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

✗ **C)** bonds were redeemed by Young Distributors at the beginning of 2005.

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.

Question #11 of 90

Question ID: 434272

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

- Common stock: 20,000 shares.
- Preferred stock A: 10,000 shares convertible into common on a 2 for 1 basis, dividend of $40,000 was declared during the

year.

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

Basic earnings per share for the year are:

✓ **A) $3.75.**

✗ **B)** $2.00.

✗ **C)** $2.75.

Explanation

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

Question #12 of 90

Question ID: 414113

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

	Consumer loans	Investment securities
✓ **A)**	**Operating**	**Operating**
✗ **B)**	Operating	Nonoperating
✗ **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.

Question #13 of 90

Question ID: 434278

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

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

What are the basic and diluted EPS for the year?

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

Explanation

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

Preferred dividends:

- 6.25% convertible preferred stock:
  (0.0625)($100)(2,315) = $14,469
- 8% convertible preferred stock:
  (0.08)($100)(2,572) = $20,576
- Preferred dividends = $14,469 + $20,576 = $35,045.

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

Diluted EPS:

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

- 6.125% convertible bonds:
  (Convertible debt interest)(1 - tax rate) / Common shares if converted
  = (0.06125)($1,000)(100)(1 − 0.4) / (33)(100)
  = $1.1136
  Because this is less than basic EPS, these convertible bonds are dilutive.
- 6.25% convertible preferred stock:
  Preferred dividend / Common shares if converted
  = (0.0625)($100) / 3.3 = $1.8939
  Because this is less than basic EPS, this convertible preferred stock is dilutive.
- 8% convertible preferred stock:
  Preferred dividend / Common shares if converted
  = (0.08)($100) / 5 = $1.60
  Because this is less than basic EPS, this convertible preferred stock is dilutive.
- Warrants:
  Because the exercise price $38 is less than average share price $52, the warrants are dilutive.

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

- 6.125% convertible bonds:
  (100 bonds)(33) = 3,300 common shares
- 6.25% convertible preferred stock:
  (2,315 preferred shares)(3.3) = 7,640 common shares
- 8% convertible preferred stock:
  (2,572 preferred shares)(5) = 12,860 common shares
- Warrants:
  [($52 - $38) / $52] × 9,986 = 2,689 common shares

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

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Question ID: 414138

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)** 1,200,000 shares.

✗ **C)** 1,500,000 shares.

Explanation

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

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Question ID: 414089

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.**

✗ **B)** $20,000.

✓ **C)** $10,000.

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.

Question #16 of 90

Question ID: 414098

Are changes in accounting principles and extraordinary items treated similarly in accordance with U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards?

	Accounting principles	Extraordinary items
✗ **A)**	**No**	**No**
✗ **B)**	Yes	Yes
✓ **C)**	Yes	No

Explanation

Treatment of a change in an accounting principle is similar under U.S. GAAP and IFRS. Under both standards, a change in accounting principle is made retrospectively. The treatment of extraordinary items differs between U.S. GAAP and IFRS. Under U.S. GAAP, extraordinary items are reported net of tax below income from continuing operations. IFRS does not permit firms to

treat transactions as extraordinary in the income statement.

Question #17 of 90

Question ID: 414117

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) $3.25.**

✗ **B)** $2.75.

✓ **C)** $1.15.

Explanation

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

Question #18 of 90

Question ID: 414062

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

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

Explanation

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

Question #19 of 90

Question ID: 414211

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

✓ **A) 250,000.**

✗ **B)** 420,000.

✗ **C)** 1,000,000.

Explanation

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

Question #20 of 90

Question ID: 414165

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

✓ **A) 248.**

✗ **B)** 744.

✗ **C)** 992.

Explanation

(992)($9) = $8928
$8928 / 12 = 744
992 − 744 = 248 new shares or [(12 − 9) / 12]992 = 248

Question #21 of 90

Question ID: 414162

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 options)($11) = $11,429
$11,429 / $16 per share
1039 − 714 = 325 shares or [(16 − 11) / 16]1,039 = 325.

Question #22 of 90

Question ID: 414063

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.

Question #23 of 90

Question ID: 414161

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) $1.15.**

✓ **B)** $1.00.

✗ **C)** $2.50.

Explanation

Number of average common shares:

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

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

= 60,000

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

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

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

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

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

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

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

Question #24 of 90

Question ID: 414218

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

✗ **A) Net profit margin.**

✓ **B)** Effective tax rate.

✗ **C)** Ratio of SG&A expense to sales.

Explanation

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

Question #25 of 90

Question ID: 414115

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) 4,500.**

✗ **B)** 5,500.

✓ **C)** 5,000.

Explanation

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

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

66,000 − 6,000 = 60,000 shares

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

Question #26 of 90

Question ID: 414191

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

✗ **A) basic EPS but not diluted EPS.**

✗ **B)** diluted EPS but not basic EPS.

✓ **C)** neither basic nor diluted EPS.

Explanation

Antidilutive securities would increase EPS if exercised or converted to common stock. Therefore we do not assume they are converted

when we calculate diluted EPS. Basic EPS is calculated before assuming any potentially dilutive securities are converted.

Question #27 of 90

Question ID: 414156

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

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

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

		Basic EPS	Diluted EPS
✓	**A)**	**$0.55**	**$0.52**
✗	**B)**	$0.64	$0.64
✗	**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 × 6,000 × 0.03) − ($1,000 × 1,000 × 0.08)] / 1,000,000 = $0.55. If the convertible preferred were converted to common stock on January 1, 6,000 × 40 = 240,000 additional shares would have been issued. Also, dividends on the convertible preferred would not have been paid.

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

Question #28 of 90

Question ID: 414198

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

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

✗ **B)** Dilutive securities decrease EPS if they are exercised or converted to common stock.

✓ **C)** Antidilutive securities decrease EPS if they are exercised or converted.

Explanation

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

Question #29 of 90

Question ID: 414065

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

✗ **A) a determined or determinable price.**

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

✓ **C)** reasonable assurance that the product will be delivered or the service will be rendered.

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.

Question #30 of 90

Question ID: 414226

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)**	**Yes**	**No**
✗ **B)**	No	No
✗ **C)**	No	Yes

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.

Question #31 of 90

Question ID: 414205

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

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

✓ **B)** 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.

✗ **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.

Question #32 of 90

Question ID: 414178

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) $9.74.**

✗ **B)** $8.49.

✓ **C)** $8.32.

Explanation

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

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

Question #33 of 90

Question ID: 414173

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

	Interest added to the numerator	Shares added to the denominator
✗ **A)**	**$3,000**	**4,500**
✓ **B)**	$1,800	4,500
✗ **C)**	$3,000	18,000

Explanation

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

Question #34 of 90

Question ID: 414184

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

diluted earnings per share (EPS), assuming the convertible bonds are dilutive?

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

Explanation

Calculating Basic Shares:

Jan 1 100,000 shares outstanding
May 1 30,000 shares issued
July 1 10% stock dividend issued

The 10% stock dividend is retroactive therefore:

110,000 shares × 12 months = 1,320,000
33,000 shares × 8 months = 264,000
Total share-month = 1,584,000
Average shares = (1,584,000 / 12) = 132,000

Calculating diluted shares:

(1,000 bonds) × (21 shares each) × (4 months) = 84,000 total share-month
84,000 / 12 = 7,000 Average shares

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

Question #35 of 90

Question ID: 414110

On January 1, 2007, Sneed Corporation purchased machinery costing $8 million with a salvage value of $1 million. For the year ended 2007, Sneed recognized depreciation expense of $3.2 million from the machinery using the double-declining-balance method. Should the depreciation expense be reported as an operating component in the income statement, and what is the estimated useful life of the machinery?

		Operating expense	Useful life
✗	**A)**	**No**	**5 years**
✗	**B)**	Yes	4 years
✓	**C)**	Yes	5 years

Explanation

Depreciation expense is reported as an operating component in the income statement. Given the first year depreciation expense of $3.2 million, and the original cost of $8 million, the declining balance percentage is 40% ($3.2 million depreciation expense / $8 million cost). The double declining balance percentage is equal to 2 / useful life = 40%. Thus, the useful life is 5 years (2 / 0.40).

Question #36 of 90

Question ID: 414229

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

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

Question #37 of 90

Question ID: 414083

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)** Percentage-of-completion method.
- ✗ **C)** Cost recovery 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.

Question #38 of 90

Question ID: 414164

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, what is the number of shares to be added to the denominator of the diluted earnings per share (EPS)?

- ✗ **A) 481.**
- ✗ **B)** 802.
- ✓ **C)** 321.

Explanation

(802)(6) = 4,812

4,812 / 10 = 481.2

802 − 481 = 321 or [(10 − 6) / 10] × 802 = 321

Question #39 of 90

Question ID: 414091

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)** $30 million.

✓ **C)** $0.

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.

Question #40 of 90

Question ID: 414145

Which type of a capital structure contains no dilutive securities?

✗ **A) Complex.**

✗ **B)** Basic.

✓ **C)** Simple.

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.

Question #41 of 90

Question ID: 414144

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

✓ **A) simple capital structure.**

✗ **B)** non-diluted capital structure.

✗ **C)** straight capital structure.

Explanation

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

Question #42 of 90

Question ID: 414096

A video rental store with a large inventory of newly released movies is attempting to determine an appropriate method of depreciation for its movies for rental. As well, it is trying to determine an appropriate method of determining the cost of its inventory of movies for sale. Which of the following treatments is *most* appropriate for the movies for rental and movies for sale?

	Movies for rental	Movies for sale
✗ **A)**	**Accelerated depreciation**	**Last-in, first-out**
✓ **B)**	Accelerated depreciation	First-in, first-out
✗ **C)**	Straight-line depreciation	Last-in, first-out

Explanation

With the movies for rental, a greater portion of the decrease in the value of newly released movies would reasonably be realized in the first year, given the rapid rate of obsolescence in view of the large number of movies available. Therefore, depreciating this pool of assets by a greater amount in the first year using an accelerated depreciation method better approximates economic depreciation than depreciating it straight line.

With the movies for sale, there are two methods available for accounting as inventory. FIFO is appropriate for inventory that has a limited shelf life and LIFO is appropriate for inventory that does not deteriorate with age. Because the movies have a very limited shelf life and will greatly deteriorate in value with age, especially after the first year, FIFO is the most appropriate method of accounting for the movies for sale.

Question #43 of 90

Question ID: 414196

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

✗ **A)** **extraordinary items and 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.

Question #44 of 90

Question ID: 414200

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

		Basic EPS	Diluted EPS
✓	**A)**	**$6.00**	**$5.45**
✗	**B)**	$5.19	$4.92
✗	**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 × $1,000 × 0.08)(1 − 0.40)] / [800,000 + (5,000 × 25)] = $5.45.

Question #45 of 90

Question ID: 414219

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) improving gross margins.**

✗ **B)** greater financial leverage.

✓ **C)** controlling operating expenses.

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.

Question #46 of 90

Question ID: 434275

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) $1.23.**

✓ **B)** $1.19.

✗ **C)** $1.50.

Explanation

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

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

Next, check for dilution.

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

Finally, calculate diluted EPS:
Diluted EPS = (9.0 - 1.5 + 1.5) / (5.0 + 2.5 + 0.034) = $1.1946.

Question #47 of 90

Question ID: 414172

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) $5.80.**

✗ **B)** $5.00.

✗ **C)** $6.00.

Explanation

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

numerator = 3,000,000 + 480,000 = 3,480,000
denominator = 350,000 + (150,000 × 4/12) + 200,000 = 600,000

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

Question #48 of 90

Question ID: 414076

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.

Question #49 of 90

Question ID: 414188

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) $3.37.**
✗ **B)** $3.12.
✓ **C)** $2.36.

Explanation

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

Step 1: *Calculate Adjusted EAC*

adjusted EAC:		net income - preferred dividends
	+	dividends on convertible preferred stock

	+	after-tax interest on convertible debt
	=	adjusted earnings available for common shares

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

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

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

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

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

Step 3: *Calculate Diluted EPS*

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

Question #50 of 90

Question ID: 414097

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

✗ **A) cash is collected.**

✗ **B)** invoices are billed.

✓ **C)** expenses are incurred.

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.

Question #51 of 90

Question ID: 414100

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

✗ **A) 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.**

✗ **B)** The general rule is retrospective application.

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

Explanation

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

Question #52 of 90

Question ID: 414225

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.

		Net income	Comprehensive income
✗	**A)**	**$490,000**	**$2,000**
✗	**B)**	$40,000	$44,000
✓	**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.

Question #53 of 90

Question ID: 414108

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

✗ **A) estimates and specific disclosures are required.**

✗ **B)** principle and specific disclosures are required.

✓ **C)** estimates and no specific disclosures are required.

Explanation

Changes in asset lives and salvage value are changes in accounting estimates and are not considered changes in accounting principle. No specific disclosures are required.

Question #54 of 90

Question ID: 414149

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's use of debt to finance its operations.**

✗ **B)** company having preferred stock outstanding.

✓ **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.

Question #55 of 90

Question ID: 434274

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) 80,000.**

✗ **B)** 10,000.

✓ **C)** 0.

Explanation

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

Question #56 of 90

Question ID: 434269

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

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

Question #57 of 90

Question ID: 414175

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) year-end market price of Zachary increased.**

✗ **B)** average market price of Zachary decreased.

✓ **C)** average market price of Zachary increased.

Explanation

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

Question #58 of 90

Question ID: 460644

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

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

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.

Question #59 of 90

Question ID: 414125

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) $1.77.**

✗ **B)** $1.66.

✗ **C)** $1.94.

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	1.000
Stock Dividend	15% on BB	0.450	12	5.400
Stock Dividend	15% on new issue	0.015	10	0.150
Repurchase (Sept .1)		-0.125	4	-0.500
			Total	*42.050*

Average shares = 42,050,000 / 12 = 3,504,167
Basic EPS = $6.2 million / 3.504 million = $1.77

Question #60 of 90

Question ID: 414177

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) $159.13.**

✗ **B)** $123.02.

✓ **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 × 12) + (60,000 × 9) - (45,000 × 3)] / 12 = 148,750. Basic EPS = $18,300,000 / 148,750 = $123.02.

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

Question #61 of 90

Question ID: 414183

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) $2.01.**

✗ **B)** $2.23.

✗ **C)** $2.41.

Explanation

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

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

Question #62 of 90

Question ID: 414086

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.S. GAAP	IFRS
✗	**A)**	**$37 million**	**$40 million**
✗	**B)**	$0	$0
✓	**C)**	$0	$50 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.

Question #63 of 90

Question ID: 414135

The following information pertains the QRK Company:

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

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

✗ **A) 1.9 million.**

✓ **B)** 1.6 million.

✗ **C)** 2.5 million.

Explanation

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

Question #64 of 90

Question ID: 414169

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) 816.**

✓ **B)** 306.

✗ **C)** 510.

Explanation

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

Question #65 of 90

Question ID: 414174

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

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

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

✗ **C)** not adjusted.

Explanation

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

Question #66 of 90

Question ID: 414190

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

✗ **A) Increase EPS.**

✓ **B)** Decrease EPS.

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

Explanation

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

Question #67 of 90

Question ID: 414223

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

	Retained earnings	Total stockholders' equity

✗	**A)**	**No effect**	**No effect**
✗	**B)**	Increase	Increase
✓	**C)**	No effect	Increase

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.

Question #68 of 90

Question ID: 414170

An analyst has gathered the following information about Zany Corp.

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

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

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

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.

Question #69 of 90

Question ID: 414208

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

- ✓ **A) potentially dilutive securities.**
- ✗ **B)** derivative securities.
- ✗ **C)** antidilutive 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.

Question #70 of 90

Question ID: 414181

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) $0.165.**

✓ **B)** $0.15.

✗ **C)** $0.180.

Explanation

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

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

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

Question #71 of 90

Question ID: 414202

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

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

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

✓ **A) $2.96.**

✗ **B)** $3.72.

✗ **C)** $3.28.

Explanation

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

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

Question #72 of 90

Question ID: 414082

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)** recognizes revenue later.

✗ **C)** results in less leverage on the balance sheet.

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.

Question #73 of 90

Question ID: 414120

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) $4.00.**

✗ **B)** $3.67.

✗ **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 million / [2 million + (4/12)(600,000)] = 8.8/2.2 = $4.00.

Question #74 of 90

Question ID: 414199

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

✓ **A) Diluted EPS does not include antidilutive securities in its computation.**

✗ **B)** To calculate diluted EPS, use net income less preferred dividends in the numerator.

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

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.

Question #75 of 90

Question ID: 414126

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

✓ **A) dividends paid to common shareholders.**

✗ **B)** the timing and number of shares issued or repurchased during the year.

✗ **C)** dividends paid to preferred 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.

Question #76 of 90

Question ID: 414116

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) $2.71.**

✗ **B)** $2.91.

✓ **C)** $2.64.

Explanation

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

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

Total share month = 317,900

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

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

Question #77 of 90

Question ID: 414069

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)** -$200,000.

✗ **C)** -$450,000.

Explanation

stage of completion = 25%(2.2 / 8.8)

revenue to be recognized = 0.25 × 10 million = 2.5 million

gross profit = 2.5 million − 2.2 million = 300,000

Question #78 of 90

Question ID: 414071

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

✗ **A) costs incurred in year 3 to total estimated costs.**

✗ **B)** costs incurred in year 3 to total billings.

✓ **C)** total costs incurred to total estimated cost.

Explanation

The percentage of completion method recognizes revenues in proportion to the proportion 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.

Question #79 of 90

Question ID: 414104

Which of the following statements regarding the income statement is *least* accurate?

✗ **A) The results of discontinued operations are reported below income from continuing operations on the income statement net of taxes.**

✗ **B)** Extraordinary items are both unusual in nature and infrequent in occurrence. Extraordinary items are disclosed net of taxes after income from continuing operations in the income statements.

✓ **C)** Items that are unusual in nature or infrequent in occurrence appear below income from continuing operations on a pretax basis.

Explanation

The key word here is "or." Unusual **or** infrequent items are *unusual **or*** infrequent**,** *but NOT both.* These items are reported (as a

separate line item) as a *component of net income from continuing operations.*

Examples of unusual **or** infrequent items include:

- Gains or losses from the disposal of a business segment (employee separation costs, plant shutdown costs, etc.)
- Gains or losses from the sale of assets or investments in subsidiaries
- Provisions for environmental remediation
- Impairments, write-offs, write-downs, and restructuring costs
- Integration expenses associated with businesses that have been recently acquired.

Question #80 of 90

Question ID: 414085

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

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

✗ **B)** the contracts are of a relatively short duration (less than one year).

✗ **C)** lack of dependable cost estimates cause forecasts to be doubtful.

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.

Question #81 of 90

Question ID: 414204

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)** Basic EPS can be less than diluted EPS.

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

Explanation

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

Question #82 of 90

Question ID: 414146

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)** 735,000.

✗ **C)** 930,000.

Explanation

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

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

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

Question #83 of 90

Question ID: 414080

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) both of these statements.**

✓ **B)** only one of these statements.

✗ **C)** neither 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.

Question #84 of 90

Question ID: 414152

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)** 167,500.

✗ **C)** 250,000.

Explanation

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

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

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

Question #85 of 90

Question ID: 414215

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

✓ **A) $5.25.**

✗ **B)** $5.32.

✗ **C)** $3.71.

Explanation

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

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

Question #86 of 90

Question ID: 414087

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

		Revenue	Income
✗	**A)**	**$1,076,923**	**$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 × 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

Question #87 of 90

Question ID: 414102

To be classified as an extraordinary item on the income statement under U.S. GAAP, the item must be:

✗ **A)** **estimated and probable.**
✓ **B)** unusual in nature and infrequent in occurrence.
✗ **C)** probable and infrequent in nature.

Explanation

Extraordinary items are unusual and infrequent events that are reported separately, net of tax "below the line." Examples are expropriations by foreign governments and uninsured losses from earthquakes, eruptions, and tornadoes.

Question #88 of 90

Question ID: 414101

Extraordinary items are:

✗ **A)** **related to the normal course of business.**
✓ **B)** unusual in nature and infrequent.
✗ **C)** unusual in nature or infrequent.

Explanation

Extraordinary items are *unusual* ***and*** *infrequent* items reported below the line net of taxes. "Below the line" means after net income from continuing operations but before net income.

- *Discontinued operations* are reported below the line net of taxes.

- *Unusual or infrequent items* are *unusual* ***or*** *infrequent*, ***but not both***. They appear (a separate line item) as a component of net income from continuing operations that must be removed if not deemed to be a component of persistent income. They are reported above the line before taxes.

- Changes in accounting principle are reported below the line net of taxes.

- Accounting errors go directly to retained earnings.

Question #89 of 90

Question ID: 414187

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

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

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

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

Explanation

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

Question #90 of 90

Question ID: 414197

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

✓ **A) $3.40.**

✗ **B)** $3.45.

✗ **C)** $3.80.

Explanation

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