CH 16 DILUTIVE SECURITIES & EPS TEXTBOOK SELF-STUDY
(note from Dr. N: I have deleted questions for you to omit, but did not renumber the remaining questions)

1. Companies issue convertible debt in order to obtain financing at a cheaper interest rate.
   A. True
   B. False

4. Convertible bonds
   A. have priority over other indebtedness.
   B. are usually secured by a first or second mortgage.
   C. pay interest only in the event earnings are sufficient to cover the interest.
   D. may be exchanged for equity securities.

5. Convertible bonds are usually converted into:
   A. preferred stock.
   B. common stock.
   C. other bonds at a lower interest rate.
   D. stock warrants.

6. Firehouse Co. has $4,000,000 of 8% convertible bonds outstanding. Each $1,000 bond is convertible into 30 shares of $30 par value common stock. The bonds pay interest on January 31 and July 31. On July 31, 2012, the holders of $1,000,000 bonds exercised the conversion privilege. On that date the market price of the bonds was 105 and the market price of the common stock was $36. The total unamortized bond premium at the date of conversion was $225,000. Firehouse should record, as a result of this conversion, a
   A. credit of $156,250 to Paid-in Capital in Excess of Par.
   B. credit of $843,750 to Paid-in Capital in Excess of Par.
   C. credit of $56,250 to Premium on Bonds Payable.
   D. loss of $1,080,000.

7. When convertible debt is retired:
   A. only losses on retirement are recognized.
   B. only gains on retirement are recognized.
   C. either a gain or a loss on retirement is recognized.
   D. neither gains nor losses are recognized.

8. When a bond issuer offers some form of additional consideration (a "sweetener") to induce conversion, the sweetener is accounted for as a(n)
   A. extraordinary item.
   B. expense.
   C. loss.
   D. none of these.
9. In accounting for the exercise of convertible preferred stock for common stock, if the par value of the common stock issued exceeds the book value of the preferred stock, Retained Earnings is debited for the difference.
   A. True
   B. False

10. When convertible preferred stock is exercised, a gain or loss is recognized on the conversion of preferred stock to common. The book value method is used to account for the transaction.
    A. True
    B. False

11. On June 30, 2012, an interest payment date, $100,000 of Summers Co. bonds were converted into 2,500 shares of Summers Co. common stock each having a par value of $5 and a market value of $54. There is $3,500 unamortized discount on the bonds. Using the book value method, Summers would record
    A. no change in paid-in capital in excess of par.
    B. an $84,000 increase in paid-in capital in excess of par.
    C. a $135,000 increase in paid-in capital in excess of par.
    D. a $3,500 increase in paid-in capital in excess of par.

13. What will the numerator of the diluted EPS calculation consist of when convertible preferred stock is being included?
    A. Net income + Preferred dividends (Net of tax effect).
    B. Net income + Preferred dividends.
    C. Net income.
    D. Net income – Preferred dividends.

14. In 2012, Gamekeeper, Inc., issued for $103 per share, 60,000 shares of $100 par value convertible preferred stock. One share of preferred stock can be converted into three shares of Gamekeeper's $25 par value common stock at the option of the preferred stockholder. In August 2013, all of the preferred stock was converted into common stock. The market value of the common stock at the date of the conversion was $30 per share. What total amount should be credited to additional paid-in capital from common stock as a result of the conversion of the preferred stock into common stock?
    A. $1,020,000.
    B. $780,000.
    C. $1,500,000.
    D. $1,680,000.

16. Nondetachable warrants do not require an allocation of the proceeds between the bonds and the warrants.
    A. True
    B. False

17. When bonds are issued with detachable stock warrants, and the fair market value is known for both securities, the price is allocated between the two securities using the incremental method.
    A. True
    B. False
18. Lakeside Corporation offered detachable 5-year warrants to buy one share of common stock (par value $5) at $20 (at a time when the stock was selling for $32). The price paid for 2,000, $1,000 bonds with the warrants attached was $205,000. The market price of the Lakeside bonds without the warrants was $180,000, and the market price of the warrants without the bonds was $20,000. What amount should be allocated to the warrants?
   A. $20,000
   B. $20,500
   C. $24,000
   D. $25,000

19. The treasury stock method would apply to which of the following securities?
   A. Stock options.
   B. Treasury stock.
   C. Preferred stock.
   D. Convertible preferred stock.

21. Detachable stock warrants outstanding should be classified as
   A. contingent liabilities.
   B. reductions of capital contributed in excess of par value.
   C. prepaid expenses.
   D. paid-in capital.

22. The issuance of warrants arises under all of the following situations except to:
   A. make different types of securities more attractive to new investors.
   B. give existing stockholders a preemptive right to purchase stock.
   C. provide compensation to executives.
   D. give bondholders the preemptive right to purchase additional stock.

23. The proceeds from the sale of debt with detachable stock warrants should be allocated between the two securities based on the:
   A. face value of the bonds.
   B. fair market value of the bonds.
   C. aggregate fair market value of the bonds and the warrants.
   D. face value of the bonds and market value of the warrants.

24. Which of the following methods has the FASB historically preferred in accounting for stock-based compensation?
   A. Fair value method.
   B. Intrinsic value method.
   C. Book value method.
   D. Par value method.

25. For which of the following securities is an allocation of the sales proceeds necessary?
   A. Convertible bonds.
   B. Bonds issued with detachable warrants.
   C. Bonds issued with nondetachable warrants.
   D. Bonds issued with either detachable or nondetachable warrants.
26. On January 1, 2012, Andover Company granted Alvaro Martinelli, an employee, an option to buy 2,000 shares of Andover Co. stock for $25 per share, the option exercisable for 5 years from date of grant. Using a fair value option pricing model, total compensation expense is determined to be $15,000. Martinelli exercised his option on September 1, 2012, and sold his 2,000 shares on December 1, 2012. Quoted market prices of Andover Co. stock during 2012 were:

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<th>Date</th>
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<td>January 1</td>
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<tr>
<td>September 1</td>
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</tr>
<tr>
<td>December 1</td>
<td>$34 per share</td>
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The service period is for three years beginning January 1, 2012. As a result of the option granted to Martinelli, using the fair value method, Andover should recognize compensation expense for 2012 on its books in the amount of:

A. $18,000.
B. $15,000.
C. $3,000.
D. $1,500.

**ADDITIONAL SELF-STUDY QUESTIONS**

1. Compensation expense resulting from a compensatory stock option plan is generally:
   A. recognized in the period of exercise.
   B. recognized in the period of the grant.
   C. allocated to the periods benefited by the employee's required service.
   D. allocated over the periods of the employee's service life to retirement.

4. Accounting for stock option plans must be based on:
   A. the fair value method.
   B. the intrinsic value method.
   C. either the fair value method or the intrinsic value method.
   D. the option-pricing method.

5. Under the fair value method, compensation expense is recorded:
   A. on the date of grant.
   B. on the date of exercise.
   C. evenly over the service period.
   D. evenly over the period from the grant date to the measurement date.

8. In computing earnings per share, treasury shares reacquired during the year are retroactively adjusted to be reacquired as of the beginning of the year.
   A. True
   B. False

9. Earnings per share is reported for both common and preferred stock.
   A. True
   B. False
10. In computing earnings per share for a simple capital structure, if the preferred stock is cumulative, the amount that should be deducted as an adjustment to the numerator (earnings) is the
   A. preferred dividends in arrears.
   B. preferred dividends in arrears times (one minus the income tax rate).
   C. annual preferred dividend times (one minus the income tax rate).
   D. none of these.

11. Which of the following is the formula for computing EPS?
   A. (Net income – Preferred dividends) ÷ Average number of shares outstanding
   B. (Net income – Preferred dividends) ÷ Weighted average number of shares outstanding
   C. (Net income + Preferred dividends) ÷ Weighted average number of shares outstanding
   D. Net income ÷ Number of shares outstanding

12. At December 31, 2012, Pearl River Company had 450,000 shares of common stock issued and outstanding, 350,000 of which had been issued and outstanding throughout the year and 100,000 of which were issued on October 1, 2012. Net income for the year ended December 31, 2012, was $2,320,000. What should be Pearl River's 2012 earnings per common share, rounded to the nearest penny?
   A. $5.16
   B. $5.45
   C. $6.19
   D. $6.63

15. In a complex capital structure, diluted earnings per share is not reported when the securities included in the capital structure are antidilutive.
   A. True
   B. False

16. Antidilutive securities are securities that upon conversion or exercise increase earnings per share.
   A. True
   B. False

17. In the diluted earnings per share computation, the treasury stock method is used for options and warrants to reflect assumed reacquisition of common stock at the average market price during the period. If the exercise price of the options or warrants exceeds the average market price, the computation would
   A. fairly present diluted earnings per share on a prospective basis.
   B. fairly present the maximum potential dilution of diluted earnings per share on a prospective basis.
   C. reflect the excess of the number of shares assumed issued over the number of shares assumed reacquired as the potential dilution of earnings per share.
   D. be antidilutive.

18. Dilutive convertible securities must be used in the computation of
   A. basic earnings per share only.
   B. diluted earnings per share only.
   C. diluted and basic earnings per share.
   D. none of these.
19. If preferred stock is cumulative, and dividends have not been declared in the past two years or in the current year, what amount should be deducted from net income in the EPS calculation?
   A. Only the dividends in arrears.
   B. Only the current year's dividend.
   C. Both the current year's dividend and the dividends in arrears.
   D. Nothing should be deducted because no dividends were declared.

20. Como Inc. had 400,000 shares of common stock issued and outstanding at December 31, 2011. On July 1, 2012 an additional 200,000 shares were issued for cash. Como also had stock options outstanding at the beginning and end of 2012 which allow the holders to purchase 60,000 shares of common stock at $28 per share. The average market price of Como's common stock was $35 during 2012. The number of shares to be used in computing diluted earnings per share for 2012 is
   A. 512,000
   B. 600,000
   C. 612,000
   D. 660,000

21. Which earnings per share amounts are reported in a complex capital structure?
   A. Basic EPS only.
   B. Diluted EPS only.
   C. Basic and diluted EPS.
   D. Basic and simple EPS.

22. The diluted EPS computation considers all of the following except the impact of:
   A. convertible securities.
   B. stock options.
   C. stock warrants.
   D. antidilutive securities.

23. The treasury stock method of computing incremental shares applies to:
   A. convertible bonds only.
   B. convertible preferred stock only.
   C. stock options and warrants.
   D. All convertible securities.

24. Complex capital structures require all of the following disclosures except:
   A. a description of pertinent rights of the various securities outstanding.
   B. a reconciliation of the numerators and denominators of the basic and diluted per share computations.
   C. the effect given preferred dividends in determining income available to common stockholders.
   D. the effect of conversions before year-end.
## SOLUTIONS

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