Multiple Choice

Identify the letter of the choice that best completes the statement or answers the question.

1. Which of the following is not potentially dilutive?
   a. Cumulative preferred stock
   b. Convertible bonds
   c. Contingent stock issuance
   d. Common stock options

2. A firm has simple earnings per share of $2.47; which of the following securities would not be dilutive?
   a. 8%, $50 par preferred stock; the tax rate is 30% and each share is convertible into 2 shares of common stock
   b. $1,000,000, 12% convertible bonds, issued at par; the tax rate is 30%, and each $1,000 bond is convertible into 30 shares of common stock
   c. 9%, $100 par convertible preferred stock, the tax rate is 30%, and each preferred share is convertible into 4 shares of common stock
   d. $1,000,000, 8% convertible bonds, issued at par; the tax rate is 30%, and each $1,000 bond is convertible into 30 shares of common stock

3. Which of the following must be disclosed in the financial statement footnotes?
   a. A reconciliation of basic EPS and diluted earnings per share
   b. Fully diluted earnings per share
   c. Primary earnings per share
   d. The numerator-effect-to-denominator-effect ratios for all potentially dilutive securities

4. The if-converted method of computing earnings per share assumes conversion of convertible securities at the
   a. beginning of the earliest period reported (or at the time of issuance, if later).
   b. beginning of the earliest period reported (regardless of time of issuance).
   c. middle of the earliest period reported (regardless of time of issuance).
   d. ending of the earliest period reported (regardless of time of issuance).

5. Which of the following is an argument made by the APB for its treatment of the proceeds from the issuance of convertible bonds?
   a. The debt and conversion right are inseparable.
   b. A firm will be able to issue convertible bonds at a lower interest rate than comparable straight bonds.
   c. Recording convertible bonds entirely as debt is consistent with the treatment of bonds issued with detachable stock warrants.
   d. At issuance, the conversion feature has no value to the issuing firm or to investors.

6. The selling price of bonds is equal to
   a. the present value of the interest payments plus the present value of the principal, discounted at the market rate of interest.
   b. the present value of the interest payments plus the present value of the principal, discounted at the stated rate of interest.
   c. the present value of the interest payments, discounted at the market rate of interest, plus the principal.
   d. the present value of the interest payments, discounted at the stated rate of interest, plus the principal.
7. How should the value of detachable warrants attached to a debt security be accounted for?
   a. No value assigned
   b. A separate portion of paid-in capital
   c. An appropriation of retained earnings
   d. A liability

8. According to SFAS 84, Induced Conversions of Convertible Debt, an issuer of a convertible security may attempt to induce prompt conversion of its convertible debt to equity securities by offering additional securities or other consideration as a sweetener. The additional consideration used to induce conversion should be reported as (a(n)
   a. reduction of the paid-in capital recognized for the new equity securities.
   b. reduction of retained earnings.
   c. extraordinary item in the current income statement.
   d. expense of the current period, but not an extraordinary item.

9. If the ratio of total liabilities to stockholders' equity increases, a ratio that must also increase is
   a. times interest earned.
   b. total liabilities to total assets.
   c. return on stockholders' equity.
   d. the current ratio.
   e. book value per share.

Problem

10. **Basic EPS and Diluted EPS with Convertible Securities.** Electra, Inc., had 200,000 shares of common stock outstanding during 2001. It also had 20,000 shares of 8%, $100 par, cumulative, convertible preferred stock and $2,000,000 of 7% convertible bonds. Each $1,000 bond is convertible into 30 shares of common stock, and each share of preferred is convertible into 2 shares of common. Electra's net income for 2001 was $2,200,000.

    **Required:**

    If the income tax rate is 30% and $160,000 of preferred dividends were declared during the year, calculate to the nearest $.01:

    a. Basic EPS
    b. Diluted EPS
11. **Effective-Interest Method Amortization, Conversion, and Extinguishment of Debt--Bonds Issued at a Premium.** On January 1, 2002, Jill Pole Productions, issued $3,000,000 of callable, 10-year, 7% bonds for $3,220,821, to provide an effective interest rate of 6%. The bonds are convertible into common stock and they pay interest annually on December 31. On December 31, 2003, bondholders converted $2,000,000 of the bonds into 80,000 shares of Pole Productions $1 par value stock when the stock was selling at $35 per share. In addition, on December 31, 2003, Pole Productions called the remaining $1,000,000 of these bonds at 104. The firm uses the effective interest method of amortization.

**Required:**

a. Prepare the December 31, 2003 journal entry to record bond interest expense.

b. Assume that the December 31, 2003 unamortized premium balance is $180,000. Prepare the journal entry to record the bond conversion. Pole Productions uses the market value method.

c. Assume that the December 31, 2003 unamortized premium balance is $180,000. Prepare the journal entry to record the call and retirement.