

True-False

1. The entity view of a firm stresses the importance of the owners' equity.
2. Dividends paid by a corporation represent a distribution of earnings to stockholders.
3. The par value of common stock is set by the state government.
4. Treasury stock is considered to be a deduction from stockholders' equity.
5. The most satisfactory method for the repurchase of a company's own shares is the Dutch auction.
6. Preferred stock that entitles its holders to share in profits with common stockholders above and beyond the stipulated dividend is participating.
7. Corporations that issue preferred stock do so because preferred stock is less risky than debt.
8. Mandatorily redeemable preferred stock is **not** considered to be equity by the FASB. The FASB requires that this type of stock be reported on the balance sheet on a separate line between liabilities and shareholders' equity.
9. Corporate distributions to shareholders are governed by state law.
10. The 1984 Revised Model Business Corporation Act redefined solvency as a situation where the fair value of assets exceed the fair value of liabilities after a distribution to shareholders.
11. Under current GAAP a stock dividend will reduce assets.
12. When a company has no convertible securities and no options or warrants outstanding, the company has a minimal capital structure.
13. A security issued together with a bond that entitles the holder to buy a designated amount of common stock at a specified price is a stock option.
14. When a company has a complex capital structure, the formula used to calculate earnings per share is called diluted earnings per share.
15. Stock options are used to provide a way for employees to build wealth and postpone taxes.
16. *APB No. 25* assumed that when options were issued that had a price equal to or above the market price of underlying common shares, the options have **no** value.
17. Opposition to the FASB review of *APB No. 25* on stock options arose because stock options do **not** involve a cash outflow, and to treat them as an expense violates materiality.
18. *SFAS No. 123* was issued as a compromise to the FASB's original position regarding stock options as it allowed companies to choose either the *APB No. 25* approach or expense the fair value of the options.
19. *SFAS No. 123* requires companies to measure the fair value of stock

options at the grant date.

20. The dollar value at which debt may be exchanged for common stock is the exercise price.
21. According to *APB No. 14*, convertible bonds must be recorded at the value of debt only.
22. By using the book value method to record the conversion of convertible bonds managers are able to protect themselves from recording extraordinary losses.
23. An employee stock ownership plan is an employee benefit pension plan that invests primarily in the common stock of the employer company.

Select the best answer from those provided.

24. The proprietary view of a firm looks at the basic accounting equation from the viewpoint of
 - a. assets.
 - b. liabilities.
 - c. owners' equity.
 - d. revenues.
25. Dividends paid by a corporation represent a/an
 - a. expense of the corporation.
 - b. liability of the corporation.
 - c. distribution of earnings to stockholders.
 - d. contra-asset item.
26. The repurchase of a company's own stock does **not** give rise to accounting gains and losses because the transactions are with
 - a. outsiders.
 - b. creditors.
 - c. owners.
 - d. outside directors.
27. Treasury stock is considered to be a/an
 - a. asset.
 - b. liability.
 - c. revenue.
 - d. contra-equity.

Table 15-1

The Vernon Corporation was formed on January 2, 2005. The company sold 20,000 shares of \$8.00 par value stock for \$20.00 per share. On July 1, 2005,

Vernon bought back 4,000 shares of stock for \$24.00 per share. The treasury stock was resold on September 1, 2005 for \$32.00 per share.

28. Refer to Table 15-1. Which one of the following is the entry to record the original sale of the stock?

a.	Cash	400,000	
	Common stock		160,000
	Paid in capital in excess of par		240,000
b.	Cash	400,000	
	Common stock		240,000
	Paid in capital in excess of par		160,000
c.	Common stock	240,000	
	Paid in capital in excess of par	160,000	
	Cash		400,000
d.	Common stock	160,000	
	Paid in capital in excess of par	240,000	
	Cash		400,000

29. Refer to Table 15-1. Which one of the following is the correct entry to record the purchase of treasury stock?

a.	Treasury stock	96,000	
	Cash		96,000
b.	Cash	96,000	
	Treasury stock		96,000
c.	Common stock	96,000	
	Cash		96,000
d.	Cash	96,000	
	Common stock		96,000

30. Refer to Table 15-1. Which one of the following is the correct entry to record the sale of treasury stock?

a.	Treasury stock	128,000	
	Common stock		128,000
b.	Cash	128,000	
	Treasury stock		96,000
	Paid in capital in excess of par		32,000
c.	Cash	128,000	

	Treasury stock		32,000
	Paid in capital in excess of par		96,000
d.	Common stock	128,000	
	Treasury stock		128,000

31. Shareholders who sell back shares of the company stock as treasury stock are

- not taxed.
- taxed at ordinary rates.
- taxed at capital gains rates.
- subject to tax penalties.

32. Financial analysts should always review stock repurchase plans carefully because

- the plans always produce above-market returns.
- the plans usually produce above-market returns.
- it is important to determine the reasons for the buyback.
- the plans are always beneficial to the shareholders.

33. When a dividend is **not** declared on preferred stock, and the common shareholders cannot receive a dividend until all past and current dividends are paid to the preferred shareholders, the preferred stock is

- cumulative.
- noncumulative
- participating.
- nonparticipating.

34. Companies with a history of net operating losses are prone to issue which one of the following to raise money?

- Debenture bonds
- Serial bonds
- Preferred stock
- Notes payable

35. Mandatorily redeemable preferred stock is **not** considered to be equity by the FASB. The FASB requires that this type of stock be reported on the balance sheet

- as a liability.
- as an equity item.
- as a temporary investment.
- on a separate line between liabilities and shareholders' equity.

- 36.** When a publicly traded company issues both common stock and preferred stock, the SEC requires that
- preferred and common stock be combined in the equity section.
 - preferred and common stock be clearly differentiated on the balance sheet.
 - all preferred stock be shown as a liability.
 - mandatorily redeemable preferred stock be shown as a liability.
- 37.** The 1984 Revised Model Business Corporation Act redefined solvency as a situation where the fair value of
- assets exceed the book value of liabilities after a distribution to stockholders.
 - assets exceed the fair value of liabilities after a distribution to shareholders.
 - liabilities exceed the fair value of assets.
 - liabilities exceed the fair value of assets after a distribution to shareholders.
- 38.** As a result of the passage of the 1984 Revised Model Business Corporation Act, it may be fair to state that
- the book value of owners' equity may not give an accurate picture of potentially legal distributions.
 - the book value of owners' equity gives an accurate picture of potentially legal distributions.
 - the book value of owners' equity never gives an accurate picture of potentially legal distributions.
 - the book value of assets gives an accurate picture of potentially legal distributions.
- 39.** A 3 for 1 stock split will reduce the per share par value and will
- decrease the number of shares proportionately.
 - increase the number of shares proportionately.
 - not impact the number of shares.
 - increase the number of shares disproportionately.
- 40.** When a company has **no** convertible securities and **no** options or warrants outstanding, the company has a
- complex capital structure.
 - simple capital structure.
 - minimal capital structure.
 - diluted capital structure.

- 41.** Basic earnings per share is calculated by dividing the sum of Net Income minus Preferred Dividends by
- Common shares outstanding.
 - Preferred shares outstanding.
 - Weighted average number of common shares outstanding.
 - Weighted average number of preferred shares outstanding.
- 42.** A company whose financing includes securities that are convertible into common stock has a
- basic capital structure.
 - complex capital structure.
 - diluted capital structure.
 - minimal capital structure.
- 43.** When a company has a complex capital structure, the formula used to calculate earnings per share is called
- diluted earnings per share.
 - basic earnings per common share.
 - complex earnings per share.
 - anti-dilutive earnings per share.
- 44.** Earnings per share data are prominent in corporate annual reports, but earnings per share suffer as a financial performance measure because EPS ignores the amount of
- revenue required to generate reported earnings.
 - capital required to generate reported earnings.
 - liabilities required to generate reported earnings.
 - expenses required to generate reported earnings.
- 45.** A company that has earnings in Year 1 equal to the earnings of Year 2 can improve its Year 2 reported earnings per share by
- selling additional common stock.
 - selling additional preferred stock.
 - repurchasing some outstanding common stock.
 - repurchasing some outstanding bonds.

Table B

The Heath Corporation reported net income for 2006 of \$177,500. Heath began the year with 100,000 shares of \$5 par value common shares outstanding and 2,500 shares of \$100 par value 8% preferred shares outstanding. On October 1, Heath sold 10,000 shares of common stock for \$6 per share. Heath paid dividends to both the common and preferred shareholders in December.

- 46.** Refer to Table B. The weighted average number of common shares

used to compute earnings per share for 2006 is

- a. 100,000.
- b. 102,500.
- c. 105,000.
- d. 110,000.

47. Refer to Table B. The basic earnings per share for 2006 is

- a. \$1.43 per share.
- b. \$1.50 per share.
- c. \$1.54 per share.
- d. \$1.73 per share.

48. Refer to Table B. If each share of preferred stock is convertible into 8 shares of common stock, the diluted earnings per share for 2006 is

- a. \$1.29 per share.
- b. \$1.45 per share.
- c. \$1.54 per share.
- d. \$1.73 per share.

Table C

Vent, Inc. reported net income of \$770,000 for 2006. Vent sold 15,000 shares of treasury stock acquired in a previous year on July 1 and 15,000 new shares on November 1. At year-end, 180,000 shares were outstanding. Vent had 20,000 shares of \$100 par value 7% preferred stock outstanding all year. Vent paid dividends to the preferred shareholders.

49. Refer to Table C. The weighted average number of common shares used to compute earnings per share for 2006 is

- a. 150,000.
- b. 160,000.
- c. 165,000.
- d. 180,000.

50. Refer to Table C. The basic earnings per share for 2006 is

- a. \$3.50 per share.
- b. \$3.94 per share.
- c. \$4.81 per share.
- d. \$6.10 per share.

51. Refer to Table C. If each share of preferred stock is convertible into 2 shares of common stock, the diluted earnings per share for 2006 is

- a. \$3.85 per share.

- b. \$3.94 per share.
- c. \$4.81 per share.
- d. \$6.10 per share.

52. The exercise price for stock option plans on the grant date is

- a. always higher than the market price of the underlying shares.
- b. always lower than the market price of the underlying shares.
- c. usually lower than the market price of the underlying shares.
- d. usually equal to or higher than the market price of the underlying shares.

53. On March 24, 1981, the Ball Company issued 5-year stock options to a group of employees. The options entitled the employees to buy 2,000 shares of stock for \$5.00 per share when the stock was selling for \$5.00 per share. Under *APB No. 25*, each employee was required to report compensation of

- a. \$ 0.
- b. \$ 2,000.
- c. \$ 4,000.
- d. \$ 10,000.

54. On May 30, 1983, the Bush Company issued 5-year stock options to a group of employees. The options entitled the employees to buy 4,000 shares of stock for \$2.00 per share when the stock was selling for \$4.00 per share. Under *APB No. 25*, each employee was required to report compensation of

- a. \$ 0.
- b. \$ 8,000.
- c. \$ 12,000.
- d. \$ 16,000.

55. Opposition to the FASB review of *APB No. 25* on stock options arose because stock options do **not** involve a cash outflow, and to treat them as an expense violates

- a. appropriate income measurement.
- b. materiality concepts.
- c. the cost benefit rule.
- d. the historical cost principle.

56. An argument raised by opponents to the FASB's proposal that employee stock options should be recognized as an expense was that it could

- a. violate the historical cost principle.
- b. violate the cost benefit rule.
- c. violate materiality concepts.
- d. jeopardize compliance with contract terms and conditions.

57. *SFAS No. 123* was issued as a compromise to the FASB's original posi-

tion regarding stock options as it

- a. required companies to continue following the approach used in *APB No. 25*.
- b. required companies to measure the fair value of stock options and charge this to expense.
- c. allowed companies to choose either the *APB No. 25* approach or expense the fair value of the options.
- d. abandoned any reference to recognition of expense for options.

58. Stock options are granted to the employees of Young Company on March 10, 2005. The employees must wait until March 10, 2009 to exercise the options. The four-year waiting period is the

- a. expected life of the options.
- b. grant period.
- c. vesting period.
- d. holding period

59. According to *SFAS No. 123*, the date when the terms for stock options are mutually agreed-upon and the stock options are awarded to employees is the

- a. vesting date.
- b. grant date.
- c. exercise date.
- d. payment date.

60. *SFAS No. 123* specifies that the compensation costs for stock options are measured

- a. at the grant date only.
- b. at the grant date and again at the vesting date.
- c. at the vesting date only.
- d. at the grant date and again at the exercise date.

61. Over the vesting period for employee stock options, *SFAS No. 123* requires that the entire compensation expense be recognized

- a. in the first year of the vesting period.
- b. in the last year of the vesting period.
- c. equally in each year of the vesting period.
- d. only if the options are exercised.

62. While **not** required to recognize compensation expense for stock options **except** under certain circumstances, firms must still report the information in

- a. the auditor's report.
- b. a footnote to the financial statements.
- c. a separate report to the SEC.
- d. a separate report to stockholders.

63. Convertible bonds are usually

- a. mortgage bonds.
- b. senior bonds.
- c. subordinated debentures.
- d. real estate bonds.

64. Call provisions on convertible bonds protect the

- a. investor against extreme stock price increases.
- b. company against extreme stock price increases.
- c. bank against extreme stock price decreases.
- d. company against extreme stock price decreases.

65. With the development of modern option pricing methods, the Accounting Principles Board would probably have reach the conclusion today that the conversion feature of convertible bonds

- a. has no value.
- b. has value.
- c. has value, but should be ignored.
- d. does not lend itself to these option pricing models.

66. Managers most often choose the method for recording the newly issued shares upon conversion of debt known as the

- a. market value method.
- b. book value method.
- c. Black-Scholes method.
- d. par value method.

67. Financial statement users must recognize that interest expense may seriously

- a. overstate the true cost of debt financing when convertible debt is used.
- b. understate the true cost of debt financing when convertible debt is used.
- c. impact the dividend rate.
- d. impact the amount of dividend declared.

68. Financial analysts are able to find much information about ESOP debt hidden in the financial statement footnotes.

- a. on the income statement.
- b. on the balance sheet.
- c. on the cash flow statement.

69. Some financial analysts argue that ESOP accounting

- a. overstates the company's true cost of employee compensation.

- b. overstates the company's true cost of goods sold.
- c. overstates the company's true cost of employee overhead.
- d. understates the company's true cost of employee compensation.

70. Prince Corp. has the following balance sheet information at December 31, 2004.

Current liabilities	\$ 545,000
Convertible bonds (\$1,000 par, 7%)	4,000,000
Common stock (\$1 par, 100,000 shares issued)	100,000
Additional paid-in capital	1,000,000
Retained earnings	2,000,000
Treasury stock (9,000 shares)	<u>(360,000)</u>
Total shareholders' equity	<u>\$ 2,740,000</u>
Total liabilities and shareholder's equity	<u>\$ 7,285,000</u>

The convertible bonds were issued at par on April 1, 2004 and are convertible into Prince's common stock at a ratio of 25 to 1. Prince did not have any treasury stock at December 31, 2003 and purchased the 9,000 shares evenly throughout 2004. The average price of the common stock for the year was \$40, and the year end price was \$45.

Prince Corp. also has 60,000 outstanding and exercisable qualified employee stock options. Employees obtain one share of stock for each option exercised. The exercise price for each option is \$21 per share.

Prince's net income for the year ended 2004 was \$292,500. Its tax rate for the year was 35%.

Required:

1. Compute **basic EPS** for the year ended December 31, 2004. Show all computations.
2. Compute **diluted EPS** for the year ended December 31, 2004. Show all computations.

71. McQueen, Inc. grants 200,000 nonqualified stock options to Robert Chalmers, the CEO, on January 1, 2002. The par value of McQueen's common stock is \$1. The exercise price on the options is \$35 per share, and the options are exercisable in two years. The stock price on January 1, 2002 is \$31 per share. This is a fixed option plan. Using the Black-Scholes option pricing model, the value of each option is estimated to be \$15.50 at the date of grant. Stock prices are \$45, \$65, and \$50 at December 31, 2002, 2003, and 2004, respectively. Robert exercises his options on April 14, 2005, when the stock price is \$57 per

share.

Required:

1. How much expense will be recognized for the year ended December 31, 2002 if McQueen uses the **intrinsic value method** of *APB Opinion No. 25* to measure compensation expense for the options?
2. How much expense will be recognized for the year ended December 31, 2003 if McQueen use the **fair value method** of *SFAS No. 123* to measure compensation expense for the options?
3. Give the journal entries needed on the date of exercise, assuming that the **fair value method** is used.
4. Explain how the tax benefits will affect McQueen's financial statements in the year of exercise assuming that it uses the **fair value method**. Give specific amounts and accounts assuming a 35% tax rate.

Answers

1. False; e
2. True; e
3. False; e
4. True; m
5. True; m
6. False; m
7. True; m
8. False; m
9. True; m
10. True; m
11. False; m
12. False; m
13. False; m
14. True; m
15. True; m
16. True; m
17. False; m
18. True; m
19. True; m
20. False; m

- 21. True; m
- 22. False; m
- 23. True; m
- 24. E; (c)
- 25. E; (c)
- 26. M; (c)
- 27. M; (d)
- 28. M; (a)
- 29. M; (a)
- 30. M; (b)
- 31. M; (c)
- 32. M; (c)
- 33. M; (a)
- 34. M; (c)
- 35. M; (a)
- 36. M; (b)
- 37. M; (b)
- 38. M; (a)
- 39. M; (b)
- 40. M; (b)
- 41. M; (c)
- 42. M; (b)
- 43. M; (a)
- 44. M; (b)
- 45. M; (c)
- 46. M; (b)
- 47. M; (c)
- 48. M; (b)
- 49. D; (b)
- 50. D; (b)
- 51. M; (a)
- 52. M; (d)
- 53. M; (a)
- 54. D; (b)
- 55. M; (a)

- 56. M; (d)
- 57. M; (c)
- 58. M; (c)
- 59. M; (b)
- 60. M; (a)
- 61. M; (c)
- 62. M; (b)
- 63. M; (c)
- 64. M; (b)
- 65. M; (b)
- 66. M; (b)
- 67. M; (b)
- 68. M; (c)
- 69. M; (d)

Explanation to Selected Multiple-Choice Questions

46. Weighted average shares outstanding:

100,000 × 9/12 =	75,000
110,000 × 3/12 =	<u>27,500</u>
Total	<u><u>102,500</u></u>

47.

$$\text{EPS} = \frac{\text{net income } \$177,500 - \text{preferred dividends } \$20,000^*}{\text{weighted average common shares outstanding } 102,500} = \frac{\$157,500}{102,500} = \$1.54$$

*(.08 × \$100 × 2,500)

$$\text{EPS} = \frac{\text{net income } \$177,500}{\text{weighted average common shares outstanding } 102,500 + \text{converted preferred } 20,000} = \frac{\$177,500}{122,500} = \$1.45 \text{ per share}$$

49. Weighted average shares outstanding:

150,000 × 6/12 =	75,000
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165,000 × 4/12 =	55,000
180,000 × 2/12 =	<u>30,000</u>
Total	<u><u>160,000</u></u>

50.

*(.07 × \$100 × 20,000)

51.

70. 1. Basic EPS:

Outstanding shares (100,000-9,000/2) = 95,500

Net income 292,500 / 95,500 = 3.06

2. Diluted EPS:

Net income	292,500
Bond interest [.75 × 4,000,000 × .07 × (1 - .35)]	<u>136,500</u>
Numerator	429,000

Basic shares	95,500
Effect of options	60,000
Proceeds from exercise (60,000 × 21)	1,260,000
Divided by average share price	40
Shares assumed to be purchased	<u>31,500</u>
Increase in shares	28,500

Effect of convertible bonds	
Average outstanding	(.75 × 4,000) 3,000
Multiplied by conversion ratio	<u>25</u>
Increase in shares	<u>75,000</u>
Denominator	<u><u>199,000</u></u>

Diluted EPS 2.16

71. Solution:

1. .5 × (38.5 - 35) × 200,000 = \$350,000

2. .5 × 15.50 × 200,000 = \$1,550,000

3.		
Cash (200,000 × \$35)	7,000,000	
Additional paid-in capital - options	3,100,000	
Common stock - par		200,000

Additional paid-in capital	
(35 + 15.5 - 1) × 200,000	9,900,000

4. Because the options are nonqualified, McQueen will receive tax benefits based on the difference between the market price at the date of exercise and the exercise price, or \$1,540,000 [.35 × 200,000 × (57 - 35)]. Deferred tax assets of \$1,085,000 (.35 × 3,100,000) would have been established in 2002 and 2003 as McQueen expensed the options. The difference between the actual tax benefit and the deferred tax asset of \$455,000 will increase McQueen's additional paid-in capital. The following entry summarizes the effects:

Income tax payable	1,540,000	
Deferred tax asset		1,085,000
Additional paid-in capital		455,000