

Problem 19-15

Information from the financial statements of Henderson-Niles Industries included the following at December 31, 2013:

Common shares outstanding throughout the year	100 million
Convertible preferred shares (convertible into 32 million shares of common)	60 million
Convertible 10% bonds (convertible into 13.5 million shares of common)	\$900 million

Henderson-Niles' net income for the year ended December 31, 2013, is \$520 million. The income tax rate is 40%. Henderson-Niles paid dividends of \$2 per share on its preferred stock during 2013.

Compute basic and diluted earnings per share for the year ended December 31, 2013.

Problem 19-15 (continued)

Numerator (Basic EPS): Net income = \$520 million; Preferred dividends = \$120 million (\$2 x 60 million)

Denominator (Basic EPS): Weighted average # shares of common stock outstanding.

$$1/1 - 12/31 \quad 100 \text{ million} \times (12/12) = \underline{100 \text{ million}}$$

Weighted average # shares 100 million

$$\text{Basic EPS} = (\$520 - \$120) \div 100 = \mathbf{\$4.00}$$

Problem 19-15 (continued)

Convertible Securities: Use the If Converted Method.

Convertible Preferred Stock:

1. Assume conversion at later of date of issue (?) or beginning of year (1/1/13). Assume conversion on 1/1/13
2. Dividend not paid = \$120 million
3. # additional shares on conversion = 32 million
4. Conversion ratio = $\$120 \div 32 = \3.75

Convertible Bonds:

1. Assume conversion at later of date of issue (?) or beginning of year (1/1/13). Assume conversion on 1/1/13
2. Interest not paid, net of tax = \$54 million [(10% x \$900 million) x 60%]
3. # additional shares on conversion = 13.5 million
4. Conversion ratio = $\$54 \div 13.5 = \4.00

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Problem 19-15 (continued)

Order of inclusion in diluted EPS

1. Convertible preferred stock with conversion ratio of \$3.75.
 $(\$520 - \$120 + \$120) \div (100 + 32) = \3.94
 $\$3.94 < \4.00 (EPS without including conversion). Therefore, the convertible preferred stock is dilutive.
2. Convertible bonds with conversion ratio of \$4.00. Because \$4.00 is greater than \$3.94, the convertible bonds are anti-dilutive and should be ignored.

Basic EPS = $(\$520 - \$120) \div 100 = \$4.00$

Diluted EPS = $(\$520 - \$120 + \$120) \div (100 + 32) = \3.94

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