## Exercise 19-21

Information from the financial statements of Ames Fabricators, Inc., included the following:

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2021</td>
<td>2020</td>
</tr>
<tr>
<td>Common shares</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Convertible P/S (convertible into 32,000 shares of common)</td>
<td>12,000</td>
<td>12,000</td>
</tr>
<tr>
<td>8% convertible bonds (convertible into 30,000 shares of common)</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Ames’ net income for the year ended December 31, 2021, is $500,000. The income tax rate is 25%. Ames paid dividends of $5 per share on its preferred stock during 2021.

Compute the basic and diluted earnings per share for the year ended December 31, 2021.

### Exercise 19-21 (continued)

#### Numerator (Basic EPS)

Net income = $500,000; Preferred dividends = $60,000 ($5 x 12,000 shares)

#### Denominator (Basic EPS)

Weighted average # shares of common stock outstanding:

\[
1/1 - 12/31 \quad 100,000 \times (12/12) = 100,000
\]

Weighted average # shares = 100,000

**Basic EPS** = \[\frac{($500,000 - $60,000)}{100,000}\] = $4.40
Exercise 19-21 (continued)

Convertible Securities, Preferred stock and Bonds: Use the If Converted Method

Preferred Stock: Assume conversion at the later of the date of issue or the beginning of the year. Assume conversion on 1/1/21.
Dividends not paid = $60,000 ($5 x 12,000 shares)
# shares issued upon conversion = 32,000 (given)
$60,000 \div 32,000 = $1.875

Bonds: Assume conversion at the later of the date of issue or the beginning of the year. Assume conversion on 1/1/21
Interest, net of tax, not paid = $60,000 \left[(8\% \times 1,000,000) \times 75\%\right]
# shares issued upon conversion = 30,000 (given)
$60,000 \div 30,000 = $2.00

Order of inclusion – smallest to largest. Therefore, first include convertible preferred stock ($1.875) and then convertible bonds ($2.00)

Exercise 19-21 (continued)

Diluted EPS: Start by incorporating the convertible preferred stock, if converted.
\[
\frac{($500,000 - $60,000 + $60,000) + (100,000 + 32,000)}{(100,000 + 32,000 + 30,000)} = $3.79
\]

Interest, net of tax divided by the additional shares issued on conversion of the convertible bonds of $2.00 is less than $3.79, so include the impact of the assumed conversion in diluted EPS

\[
\text{Diluted EPS} = \frac{($500,000 - $60,000 + $60,000 + $60,000) + (100,000 + 32,000 + 30,000)}{162,000} = $3.46
\]

Already computed Basic EPS = \[
\frac{($500,000 - $60,000)}{100,000} = $4.40
\]