

Summary

This chapter has reviewed certain types of analysis that particularly concern investors. Ratios relevant to this analysis include the following:

$$\begin{aligned} \text{Degree of Financial Leverage} &= \frac{\text{Earnings Before Interest and Tax}}{\text{Earnings Before Tax}} \\ \text{All-Inclusive Degree of Financial Leverage} &= \frac{\text{Earnings Before Interest, Tax, Noncontrolling Interest, Equity Income, and Nonrecurring Items}}{\text{Earnings Before Tax, Noncontrolling Interest, Equity Income, and Nonrecurring Items}} \\ \text{Earnings per Share} &= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted Average Number of Common Shares Outstanding}} \\ \text{Price/Earnings Ratio} &= \frac{\text{Market Price per Share}}{\text{Diluted Earnings per Share, Before Nonrecurring Items}} \\ \text{Percentage of Earnings Retained} &= \frac{\text{Net Income Before Nonrecurring Items} - \text{All Dividends}}{\text{Net Income Before Nonrecurring Items}} \\ \text{Dividend Payout} &= \frac{\text{Dividends per Common Share}}{\text{Diluted Earnings per Share Before Nonrecurring Items}} \\ \text{Dividend Yield} &= \frac{\text{Dividends per Common Share}}{\text{Market Price per Common Share}} \\ \text{Book Value per Share} &= \frac{\text{Total Shareholders' Equity} - \text{Preferred Stock Equity}}{\text{Number of Common Shares Outstanding}} \\ \text{Materiality of Options} &= \frac{\text{Net Income Before Nonrecurring Items Not Including Option Expense} - \text{Net Income Before Nonrecurring Items Including Option Expense}}{\text{Net Income Before Nonrecurring Items Not Including Option Expense}} \end{aligned}$$

Questions

- Q 9-1** Give a simple definition of *earnings per share*.
- Q 9-2** Assume that a corporation is a nonpublic company. Comment on the requirement for this firm to disclose earnings per share.
- Q 9-3** Keller & Fink, a partnership, engages in the wholesale fish market. How would this company disclose earnings per share?
- Q 9-4** Dividends on preferred stock total \$5,000 for the current year. How would these dividends influence earnings per share?
- Q 9-5** The denominator of the earnings per share computation includes the weighted average number of common shares outstanding. Why use the weighted average instead of the year-end common shares outstanding?
- Q 9-6** Preferred dividends decreased this year because some preferred stock was retired. How would this influence the earnings per share computation this year?
- Q 9-7** Retroactive recognition is given to stock dividends and stock splits on common stock when computing earnings per share. Why?
- Q 9-8** Why do many firms try to maintain a stable percentage of earnings retained?
- Q 9-9** Define *financial leverage*. What is its effect on earnings? When is the use of financial leverage advantageous and disadvantageous?
- Q 9-10** Given a set level of earnings before interest and tax, how will a rise in interest rates affect the degree of financial leverage?
- Q 9-11** Why is the price/earnings ratio considered a gauge of future earning power?
- Q 9-12** Why does a relatively new firm often have a low dividend payout ratio? Why does a firm with a substantial growth record and/or substantial growth prospects often have a low dividend payout ratio?

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