

Chapter 2

Review of Accounting

Discussion Questions

- 2-1. Discuss some financial variables that affect the price-earnings ratio.

The price-earnings ratio will be influenced by the earnings and sales growth of the firm, the risk or volatility in performance, the debt-equity structure of the firm, the dividend payment policy, the quality of management, and a number of other factors. The ratio tends to be future-oriented, and the more positive the outlook, the higher it will be.

- 2-2. What is the difference between book value per share of common stock and market value per share? Why does this disparity occur?

Book value per share is arrived at by taking the cost of the assets and subtracting out liabilities and preferred stock and dividing by the number of common shares outstanding. It is based on the historical cost of the assets. Market value per share is based on the current assessed value of the firm in the marketplace and may bear little relationship to original cost. Besides the disparity between book and market value caused by the historical cost approach, other contributing factors are the growth prospects for the firm, the quality of management, and the industry outlook. To the extent these are quite negative or positive; market value may differ widely from book value.

- 2-3. Explain how depreciation generates actual cash flows for the company.

The only way depreciation generates cash flows for the company is by serving as a tax shield against reported income. This non-cash deduction may provide cash flow equal to the tax rate times the depreciation charged. This much in taxes will be saved, while no cash payments occur.

- 2-4. What is the difference between accumulated depreciation and depreciation expense? How are they related?

Accumulated depreciation is the sum of all past and present depreciation charges, while depreciation expense is the current year's charge. They are related in that the sum of all prior depreciation expense should be equal to accumulated depreciation (subject to some differential related to asset write-offs).