

What They Don't Teach at BINC

Preferred Procedure Simplified



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Objectives

- What Preferred Procedure is
- Why use Preferred Procedure?
- The relationship of the Income Statement, Preferred Procedure and the Stock Selection Guide (SSG)
- Understanding the relationships on the SSG and what you need to research
- Working with Preferred Dividends



Preferred Procedure

Preferred Procedure is also known as:
“The Business Model”



It is based on a
“*SIMPLIFIED*” Income Statement.

The Income Statement

The **Income Statement** may also be referred to as *Statement of Earnings* or *Statement of Operations*.

The Income Statement

- Gives one important perspective on the health of a business -- its *profitability*.
- Measures a company's performance *over a specified period of time*. For example:
 - Annual: Fifty-two weeks ended Sept. 24, 2011
 - Quarter: Thirteen weeks ended March 24, 2012

The Income Statement

Provides information on:

- How a company performed, where it is heading, and what future cash flow or profitability might be.
- Ability of managers to make sales, control expenses, and thereby earn a profit.
- Growth trends in **Sales** and **Net Income**, which are particularly important to watch.

The Income Statement

- I've done my homework and researched the company.
- I've collected data.
- I have 10 years of Income Statements?
What do I do with them??

What is the best way to study my 10 years of Income Statements?



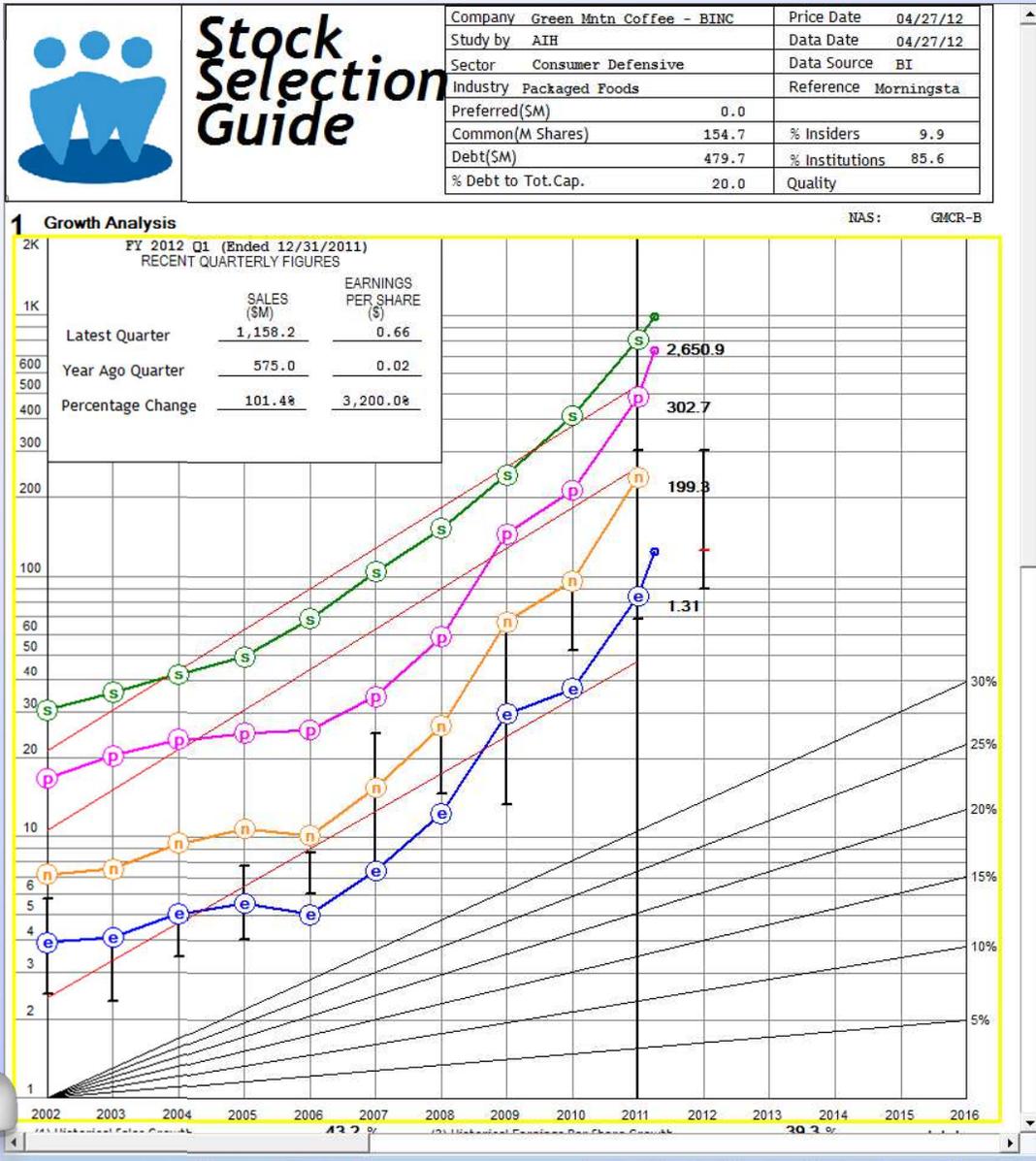
What They Don't Teach at BINC

Green Mountain Coffee Roasters, Inc.
Consolidated Statements of Operations
(Dollars in thousands except per share data)

	Fifty-two weeks ended September 24, 2011	Fifty-two weeks ended September 25, 2010	Fifty-two weeks ended September 26, 2009
Net sales	\$ 2,650,899	\$ 1,356,775	\$ 786,135
Cost of sales	1,746,274	931,017	540,744
Gross profit	904,625	425,758	245,391
Selling and operating expenses	348,696	186,418	121,350
General and administrative expenses	187,016	100,568	47,655
Patent litigation settlement	—	—	(17,000)
Operating income	368,913	138,772	93,386
Other income (expense), net	648	85	(662)
Loss on financial instruments, net	(6,245)	(354)	—
Loss on foreign currency, net	(2,912)	—	—
Interest expense	(57,657)	(5,294)	(4,693)
Income before income taxes	302,747	133,209	88,031
Income tax expense	(101,699)	(53,703)	(33,592)
Net Income	\$ 201,048	\$ 79,506	\$ 54,439
Net income attributable to noncontrolling interests	1,547	—	—
Net income attributable to GMCR	\$ 199,501	\$ 79,506	\$ 54,439
Basic income per share:			
Basic weighted average shares outstanding	146,214,860	131,529,412	113,979,588
Net income per common share—basic	\$ 1.36	\$ 0.60	\$ 0.48
Diluted income per share:			
Diluted weighted average shares outstanding	152,142,434	137,834,123	120,370,659
Net income per common share—diluted	\$ 1.31	\$ 0.58	\$ 0.45



What They Don't Teach at BINC



What They Don't Teach at BINC

Consolidated Statements of Earnings

amounts in millions, except per share data

	2004	2003	2002
NET SALES	64,816	\$58,247	\$53,553
Cost of Merchandise Sold	44,236	40,139	37,406
GROSS PROFIT	20,580	18,108	16,147
Operating Expenses:			
Selling and Store Operating	12,502	11,180	10,163
Pre-Opening	86	96	117
General and Administrative	1,146	1,022	935
Total Operating Expenses	13,734	12,298	11,215
OPERATING INCOME	6,846	5,830	4,932
Interest Income (Expense):			
Interest and Investment Income	59	79	53
Interest Expense	(62)	(37)	(28)
Interest, net	(3)	42	25
EARNINGS BEFORE PROVISION FOR INCOME TAXES	6,843	5,872	4,957
Provision for Income Taxes	2,534	2,208	1,913
NET EARNINGS	4,309	\$ 3,664	\$ 3,044
Weighted Average Common Shares	2,333	2,336	2,335
BASIC EARNINGS PER SHARE	\$ 1.88	1.57	\$ 1.30
Diluted Weighted Average Common Shares	3,289	3,344	2,353
DILUTED EARNINGS PER SHARE	\$ 1.88	1.56	\$ 1.29

(1) Fiscal years ended February 1, 2004 and February 2, 2003 include 52 weeks. Fiscal year ended February 2, 2002 includes 53 weeks.

See accompanying Notes to Consolidated Financial Statements.

The Simplified Income Statement

1 Net Sales

2 - Expenses

3 Earnings Before Provision for Income Taxes

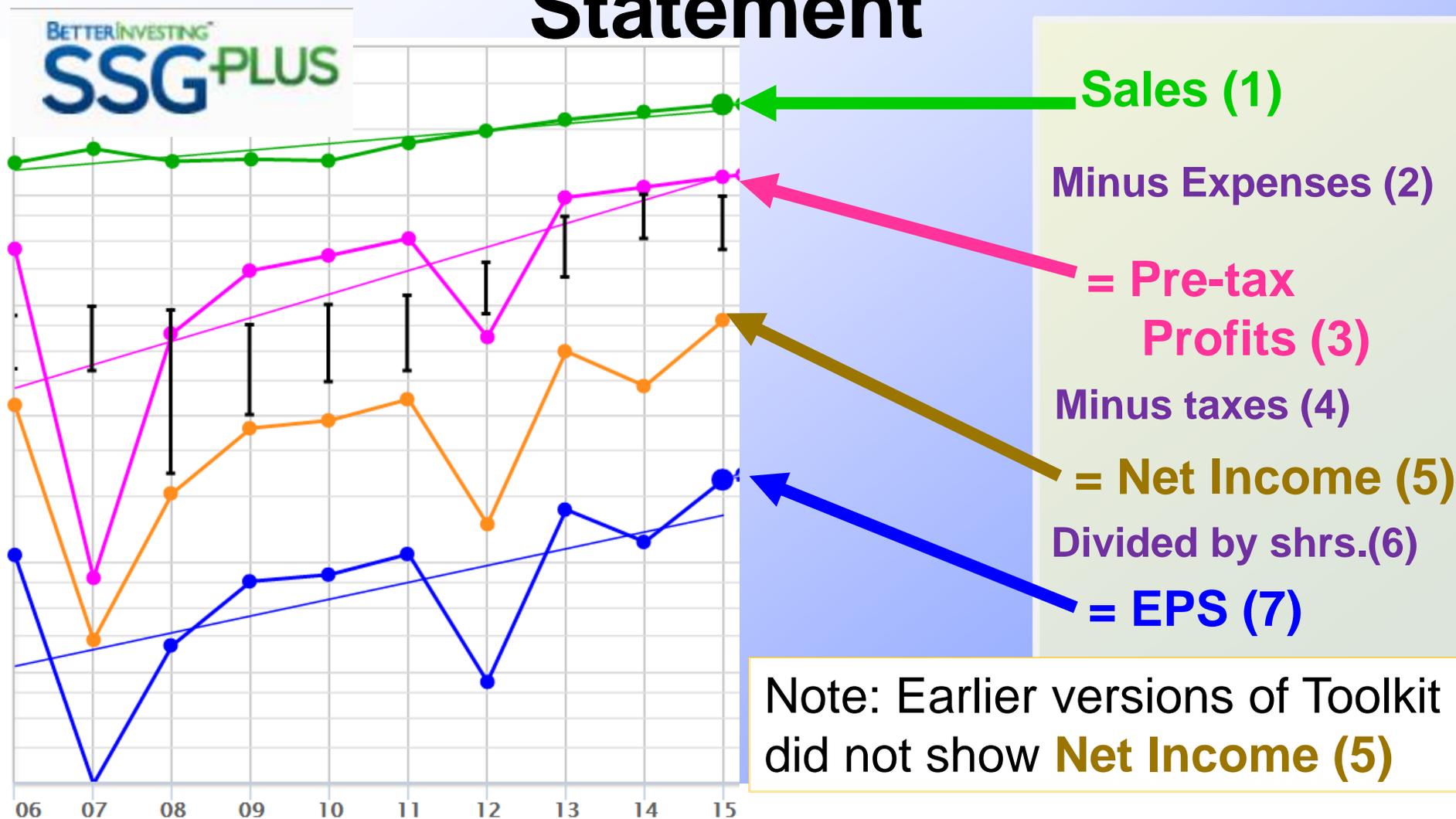
4 - Taxes

5 Net Earnings

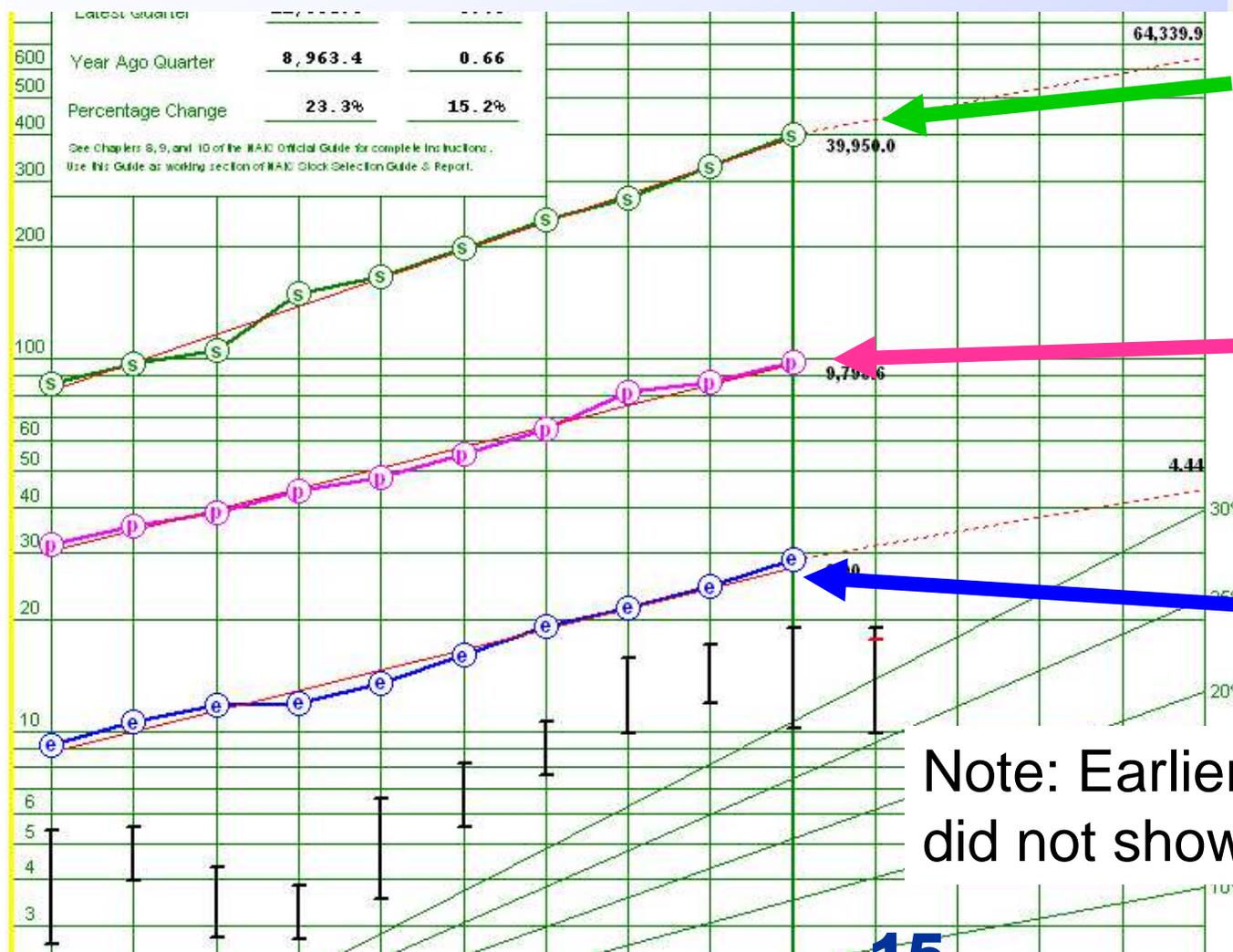
6 ÷ Diluted Weighted Average Common Shares

7 Diluted Earnings Per Share (EPS)

The Simplified Income Statement



The Simplified Income Statement



Sales (1)

Minus Expenses (2)

= Pre-tax Profits (3)

Minus taxes (4)

Divided by shrs.(6)

= EPS (7)

Why Use Preferred Procedure?

- Often **EPS** is not as well behaved as **Sales**
- **EPS** is affected by:
 - **Sales**
 - **Profit Margins**,
 - **Tax Rates**, and
 - **Shares Outstanding**



Why Use Preferred Procedure



- By looking at each component we get a better picture of what future **EPS** might reasonably be.
- For a less consistent **EPS** history, Preferred Procedure can help focus a future **EPS** estimate.

What They Don't Teach at BINC

Sales

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	0.0%	<input type="checkbox"/>	<input type="text" value="0.0"/>	64,816.0
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	9.8%	<input type="checkbox"/>	<input type="text" value="0.0"/>	-58,464.0
Less Taxes(Last yr. Tax Rate):	37.1%	<input type="checkbox"/>	<input type="text" value="0.0"/>	-2,356.6
Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	<input type="text" value="0.0"/>	0.0
Projected 5 Yr Total Earnings				\$ 3,995.4
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0	<input type="checkbox"/>	<input type="text" value="0.0"/>	<input type="text" value="1.79"/>

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by "Preferred Procedure":	<input type="text" value="1.79"/>	-1.0
<input checked="" type="radio"/> Projected EPS:		<input type="text" value=""/>
<input type="radio"/> Other:	<input type="text" value="0.00"/>	0.0
Analysts' Estimate:	3.51	

Annual Sales

1994	12,476.7
1995	15,470.4
1996	19,535.5
1997	24,156.0
1998	30,219.0
1999	38,434.0
2000	45,738.0
2001	53,553.0
2002	58,247.0
2003	64,816.0

What They Don't Teach at BINC

Pre-Tax Profit

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	10.0% <input checked="" type="checkbox"/>	10.0	\$104,386.8
Less Expenses (5 Yr Avg % Pre Tax Profit Margin):	9.8% <input type="checkbox"/>	0.0	-94,156.9
Pre-Tax Profit			\$10,229.9
Less Taxes (Last yr. Tax Rate):	37.1% <input type="checkbox"/>	0.0	-3,795.3
Less Preferred Dividends (Current Pref'd Div):	\$0.0 <input type="checkbox"/>	0.0	0.0
Projected 5 Yr Total Earnings			\$ 6,434.6
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0 <input type="checkbox"/>	0.0	2.88

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by "Preferred Procedure":	2.88	8.9
<input checked="" type="radio"/> Projected EPS:		
<input type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	3.51	

% Pretax Profit Margin (2A)

1994	8.1
1995	7.8
1996	7.9
1997	7.8
1998	8.8
1999	9.9
2000	9.2
2001	9.3
2002	10.1
2003	10.6

OK
Cancel

What They Don't Teach at BINIC

Tax Rate

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	10.0% <input checked="" type="checkbox"/>	10.0	\$104,386.8
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	9.8% <input checked="" type="checkbox"/>	11.2	-92,695.5
Less Taxes(Last yr. Tax Rate):	37.1% <input type="checkbox"/>	0.0	-4,337.5
Less Preferred Dividends (Current Pref'd Div):	\$0.0 <input type="checkbox"/>	0.0	0.0
Projected 5 Yr Total Earnings			\$ 7,353.8
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0 <input type="checkbox"/>	0.0	3.29

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by "Preferred Procedure":	3.29	11.8
<input checked="" type="radio"/> Projected EPS:		
<input type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	3.51	

Annual % Tax Rate

1994	38.3%
1995	38.8%
1996	38.7%
1997	38.6%
1998	38.2%
1999	38.4%
2000	38.6%
2001	38.4%
2002	37.7%
2003	37.1%

OK

Cancel

?

What They Don't Teach at BINC

Preferred Dividends

 Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator) 

Preferred Procedure Calculation

Projected 5 Year Sales @:	10.0% <input checked="" type="checkbox"/>	10.0	\$104,386.8
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	9.8% <input checked="" type="checkbox"/>	11.2	-92,695.5
Less Taxes(Last yr. Tax Rate):	37.1% <input checked="" type="checkbox"/>	37.0	-4,325.8
Less Preferred Dividends (Current Pref'd Div):	<input checked="" type="checkbox"/> \$0.0	0.0	0.0
Projected 5 Yr Total Earnings			\$ 7,365.5
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0 <input type="checkbox"/>	0.0	3.30

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by "Preferred Procedure":	3.30	11.9
<input type="radio"/> Projected EPS:		
<input checked="" type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	3.51	

What They Don't Teach at BINIC

Shares Outstanding

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator)

Preferred Procedure Calculation

Projected 5 Year Sales @:	10.0%	<input checked="" type="checkbox"/>	10.0	\$104,386.8
Less Expenses(5 Yr Avg % Pre Tax Profit Margin):	9.8%	<input checked="" type="checkbox"/>	11.2	-92,695.5
Less Taxes(Last yr. Tax Rate):	37.1%	<input checked="" type="checkbox"/>	37.0	-4,325.8
Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	0.0	0.0
Projected 5 Yr Total Earnings				\$ 7,365.5
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0	<input type="checkbox"/>	0.0	3.30

Make Earnings Per Share Selection Here:

	EPS \$	EPS % Growth
<input type="radio"/> EPS by "Preferred Procedure":	3.30	11.9
<input type="radio"/> Projected EPS:		
<input checked="" type="radio"/> Other:	0.00	0.0
Analysts' Estimate:	3.51	

Annual Shares Outstanding

1994	2,040.0
1995	2,147.0
1996	2,162.0
1997	2,196.0
1998	2,213.0
1999	2,304.0
2000	2,324.0
2001	2,346.0
2002	2,293.0
2003	2,257.0

OK
Cancel

EPS Five Years in the Future

Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator						
Preferred Procedure Calculation						
1	Projected 5 Year Sales (G):	10.0%	<input checked="" type="checkbox"/>	<input type="text" value="10.0"/>	\$104,386.8	
2	Less Expenses (5 Yr Avg % Pre Tax Profit Margin):	9.8%	<input checked="" type="checkbox"/>	<input type="text" value="11.2"/>	- 92,695.5	11,691.3
4	Less Taxes (Last yr. Tax Rate):	37.1%	<input checked="" type="checkbox"/>	<input type="text" value="37.0"/>	- 4,325.8	
	Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	<input type="text" value="0.0"/>	0.0	
5	Projected 5 Yr Total Earnings			=	\$ 7,365.5	
6	Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0	<input checked="" type="checkbox"/>	<input type="text" value="2175.0"/>		<input type="text" value="3.39"/>

Note: 3 Pre-Tax Profit is not shown.

Questions?



LET'S TAKE A CLOSER LOOK

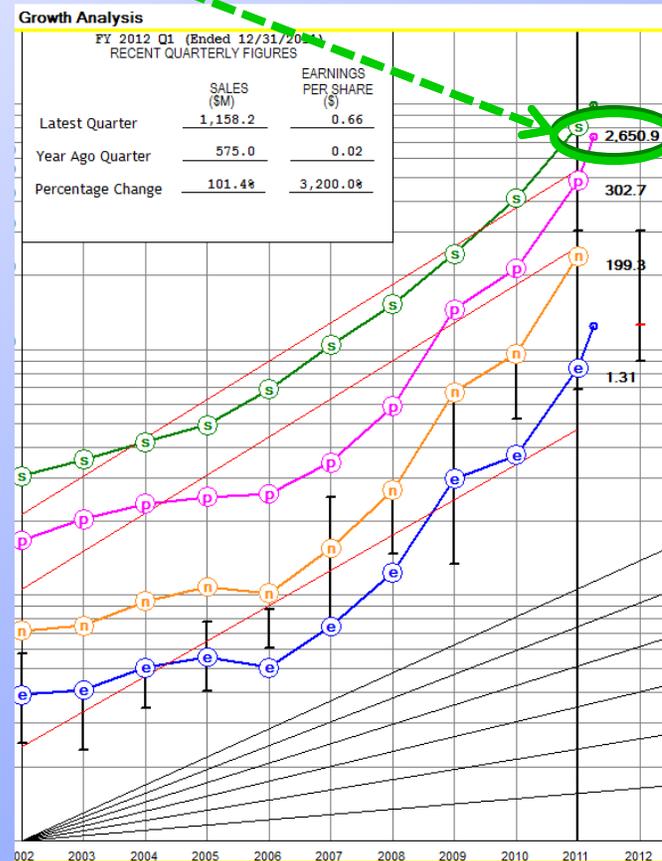


What They Don't Teach at BINC

Net sales	\$ 2,650,899
Cost of sales	1,740,274
Gross profit	904,625
Selling and operating expenses	348,696
General and administrative expenses	187,016
Patent litigation settlement	—
Operating income	368,913
Other income (expense), net	648
Loss on financial instruments, net	(6,245)
Loss on foreign currency, net	(2,912)
Interest expense	(57,657)
Income before income taxes	302,747
Income tax expense	(101,699)
Net Income	\$ 201,048
Net income attributable to noncontrolling interest	1,547
Net income attributable to GMCR	\$ 199,501
Basic income per share:	
Basic weighted average shares outstanding	146,214,860
Net income per common share—basic	\$ 1.36
Diluted income per share:	
Diluted weighted average shares outstanding	152,142,434
Net income per common share—diluted	\$ 1.31

Fifty-two weeks ended
September 24,
2011

What is our first
(top) line?



What They Don't Teach at BINC

	Fifty-two weeks ended September 24, 2011
Net sales	\$ 2,650,899
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1st step down the
Income Statement

Results in
Gross Profit.

Cost of
Sales

What They Don't Teach at BINC

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Next step down the
Income Statement

Results in
Operating Income.

Expenses to operate
the business –
Operating Expenses.

It's Simple

Net Sales

- Cost of Sales

= **Gross Profit**

- Selling Expenses

- General and Administrative Exp.

= **Operating Income**

=====

The Non-Operating Section

- This section frequently consists primarily of Interest (or Other) Income and Interest Expense.
 - Interest and investment income is earned and reported when a company invests in certificates of deposits, treasury bills or notes, or the stocks and bonds of other companies.
 - Interest Expense is a payment that the company makes for the use of another company's money (for example: notes, mortgages, and bonds).

What They Don't Teach at BINC

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Operating income	368,913
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Loss on financial instruments, net	(6,245)
Loss on foreign currency, net	(2,912)
Interest expense	(57,657)
Income before income taxes	302,747
Income tax expense	(101,699)
Net Income	\$ 201,048
Net income attributable to common shareholders	1,547
Net income attributable to preferred shareholders	\$ 199,501
Basic income per share:	
Basic weighted average shares outstanding	146,214,860
Net income per common share—basic	\$ 1.36
Diluted income per share:	
Diluted weighted average shares outstanding	152,142,434
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Next step down the
Income Statement

Results in
Income before
income taxes.

Non-Operating Items
(May be income or
expense items).

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We are going to call
this entire section
“Expenses”

Income Before Income Taxes

We know **Income Before Income Taxes** by another name !!!

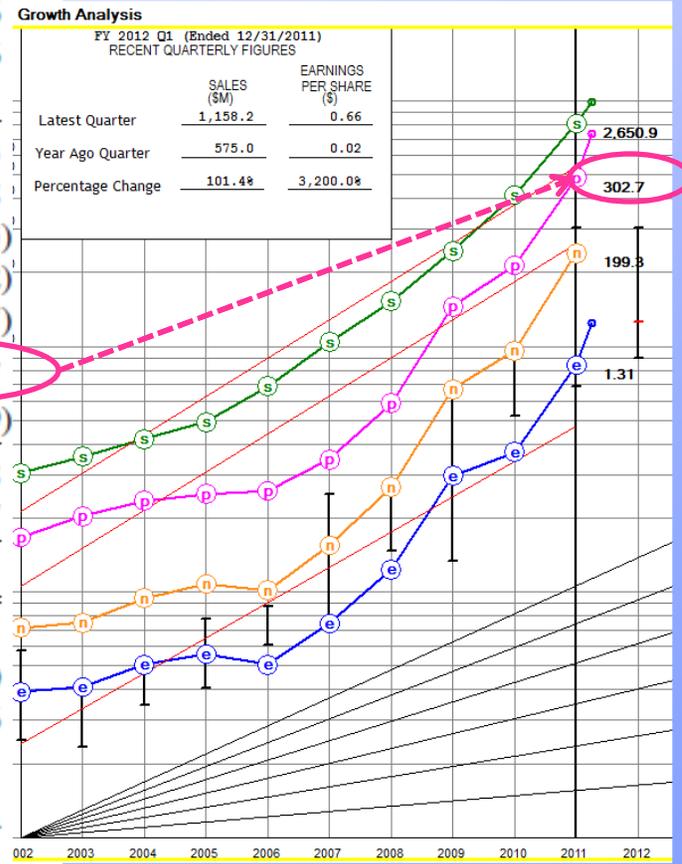
Pre-tax Profit

What They Don't Teach at BINC

What is the second line?

	Fifty-two weeks ended September 24, 2011
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Pre-tax Profit



What They Don't Teach at BINC

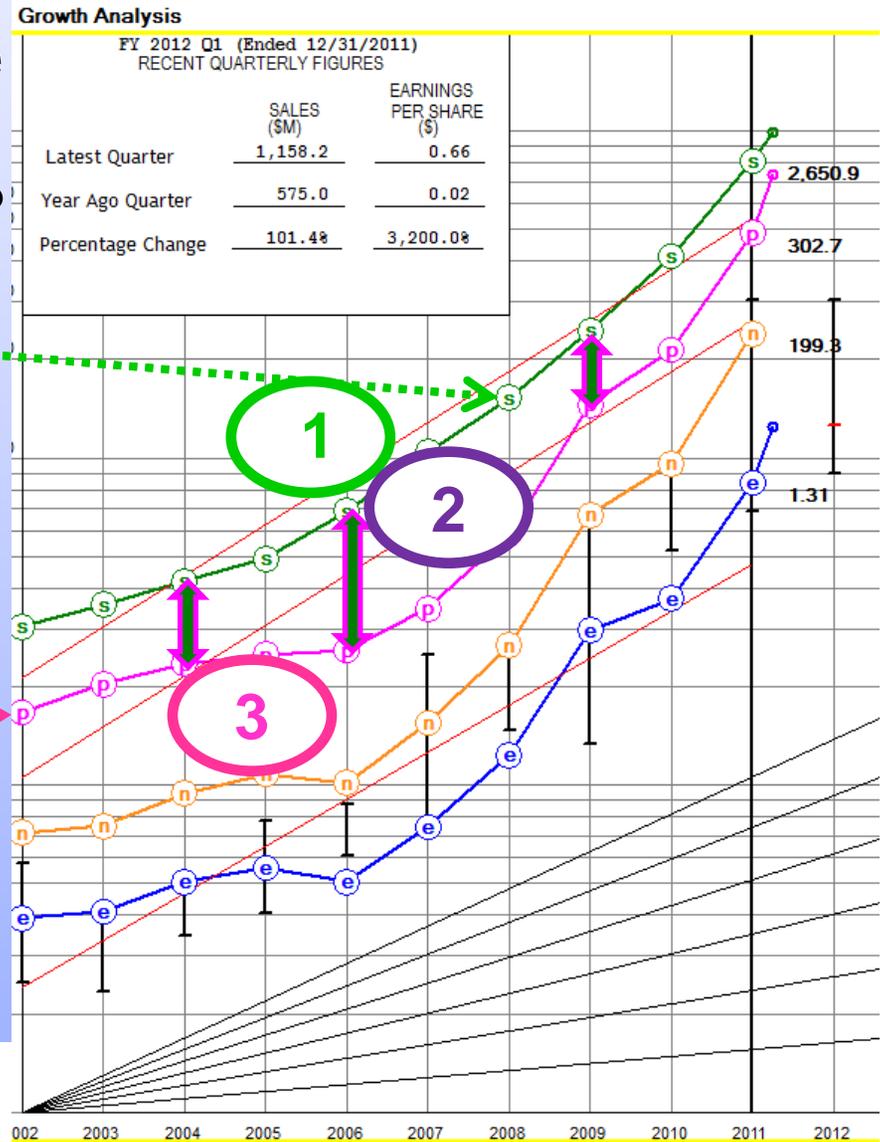
What is Happening?

The distance between the **Sales** line and the **Pre-tax Profit** line is changing. What might be the cause?

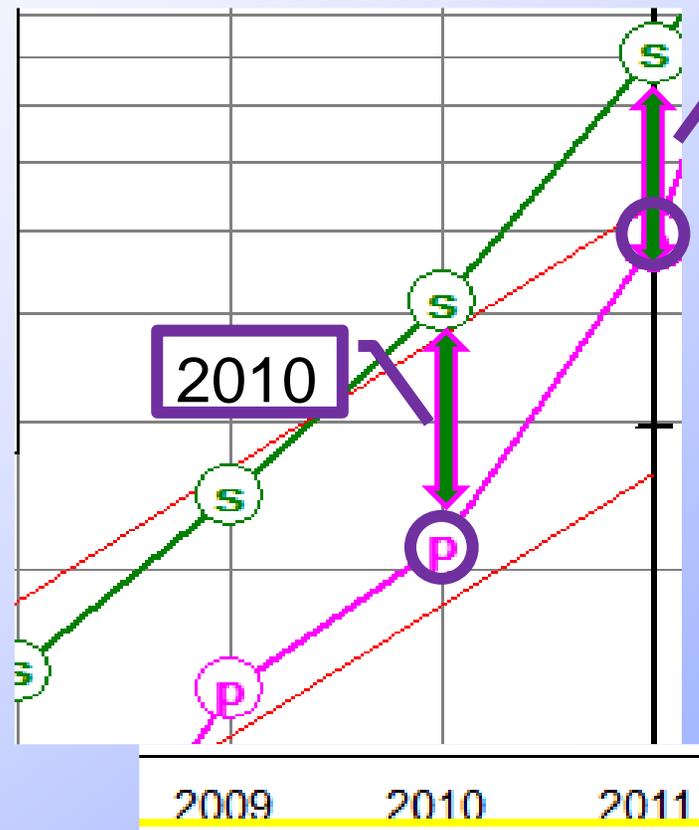
Net sales	.....
Cost of sales	.....
Gross profit	.....
Selling and operating expenses	....
General and administrative expenses	.....
Patent litigation settlement	.....
Operating income	.....
Other income (expense), net	.....
Loss on financial instruments, net	....
Loss on foreign currency, net	.....
Interest expense	.....
Income before income taxes	.....

One or more of the items in the box is changing!

Expenses !



Let's Look a Little Closer (Option 1)



2011

From 2010 to 2011
Sales and **Pre-tax Profit** moved closer!

The space between the lines –
Expenses
– got smaller

Let's Look a Little Closer (Option 2)

Move the lines so that the first year of data overlaps



Let's Look a Little Closer (Option 3)

Move the trend lines so that the first year overlaps



Questions?



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Next step down the
Income Statement

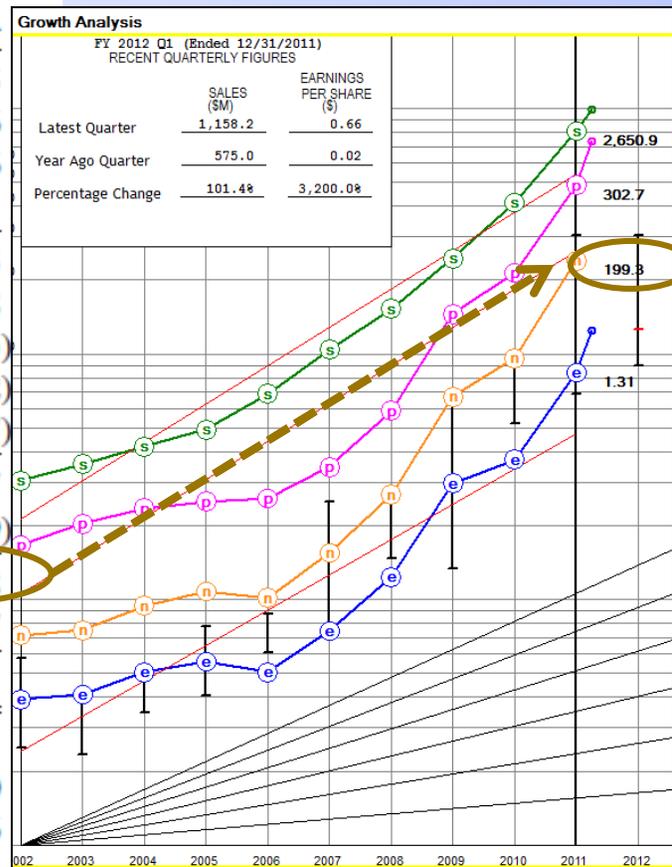
Income taxes

Results in
Net Income.

What They Don't Teach at BINC

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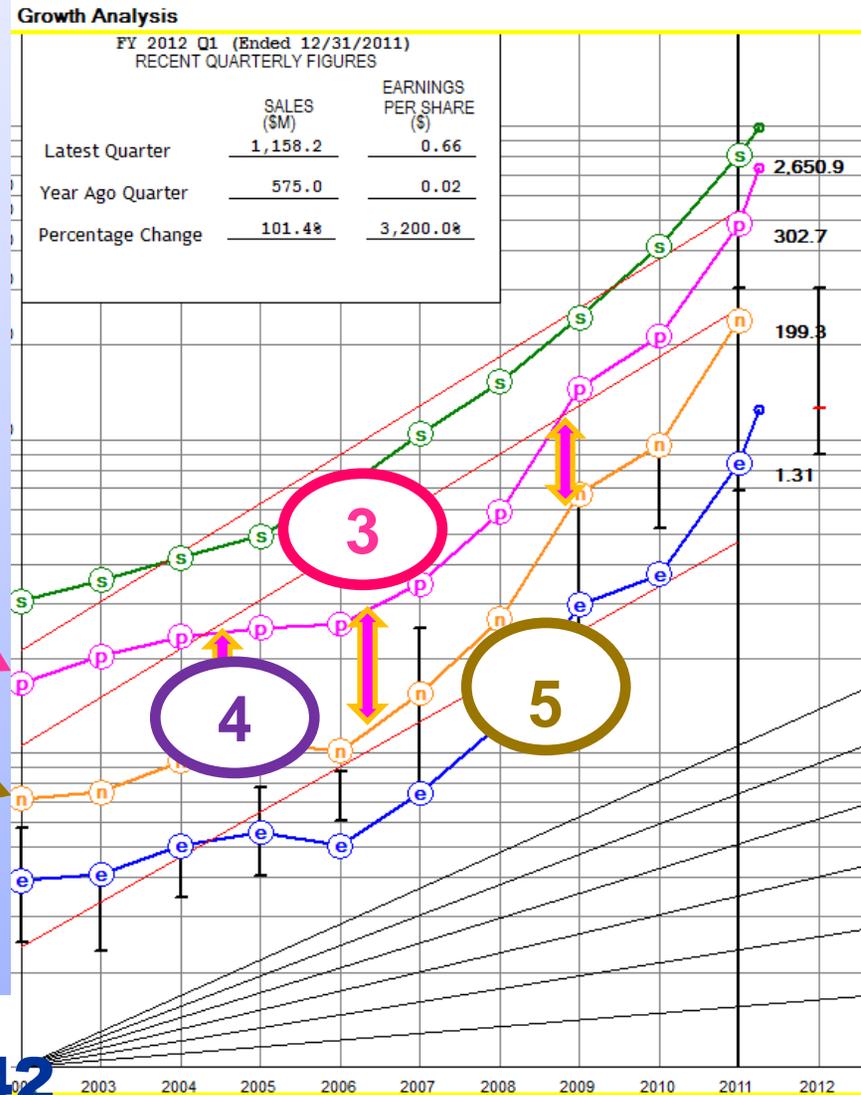
What is Happening?

The distance between the **Pre-tax Profit** line and the **Net Income** line is changing. What might be the cause?

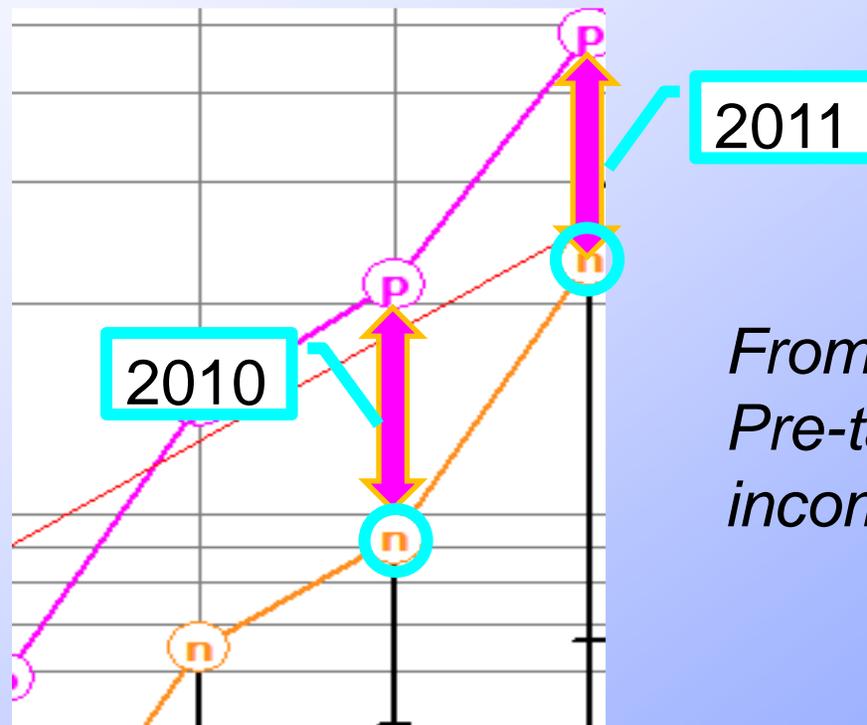
Income before income taxes ...
Income tax expense
Net Income

Only one thing is happening in between!

Taxes !



Let's Look a Little Closer



*From 2010 to 2011
Pre-tax Profit and net
income moved closer!*

What They Don't Teach at BINC

	Fifty-two weeks ended September 24, 2011
Net sales	\$ 2,650,899
Cost of sales	1,746,274
Gross profit	904,625
Selling and operating expenses	348,696
General and administrative expenses	187,016
Patent litigation settlement	—
Operating income	368,913
Other income (expense), net	648
Loss on financial instruments, net	(6,245)
Loss on foreign currency, net	(2,912)
Interest expense	(57,657)
Income before income taxes	302,747
Income tax expense	(101,699)
Net Income	\$ 201,048
Net income attributable to noncontrolling interests	1,547
Net income attributable to GMCR	\$ 199,501
Basic income per share:	
Basic weighted average shares outstanding	146,214,860
Net income per common share—basic	\$ 1.36
Diluted income per share:	
Diluted weighted average shares outstanding	152,142,434
Net income per common share—diluted	\$ 1.31

Final step down the
Income Statement

Shares Outstanding

Results in
Net Income
Per Share.

What They Don't Teach at BINC

What is our final line?

Net sales	
Cost of sales	
Gross profit	
Selling and operating expenses	
General and administrative expenses	
Patent litigation settlement	
Operating income	
Other income (expense), net	
Loss on financial instruments, net	
Loss on foreign currency, net	
Interest expense	
Income before income taxes	
Income tax expense	
Net Income	
Net income attributable to noncontrolling interests	
Net income attributable to Co	
Basic income per share:	
Basic weighted average shares outstanding	
Net income per common share—basic	
Diluted income per share:	
Diluted weighted average shares outstanding	
Net income per common share—diluted	

Fifty-two weeks ended
September 24,
2011

\$ 2,650,899

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(6,245)

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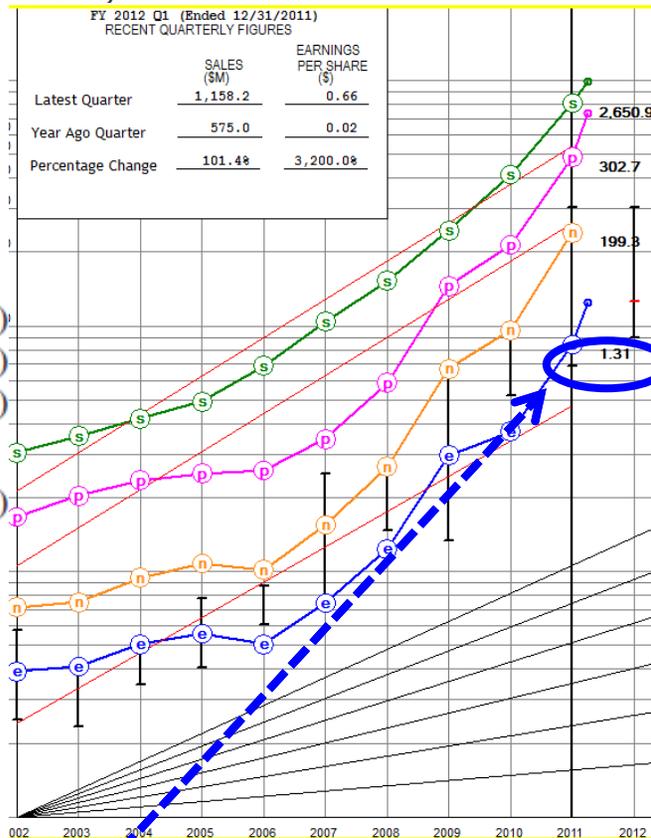
146,214,860

\$ 1.36

152,142,434

\$ 1.31

Growth Analysis



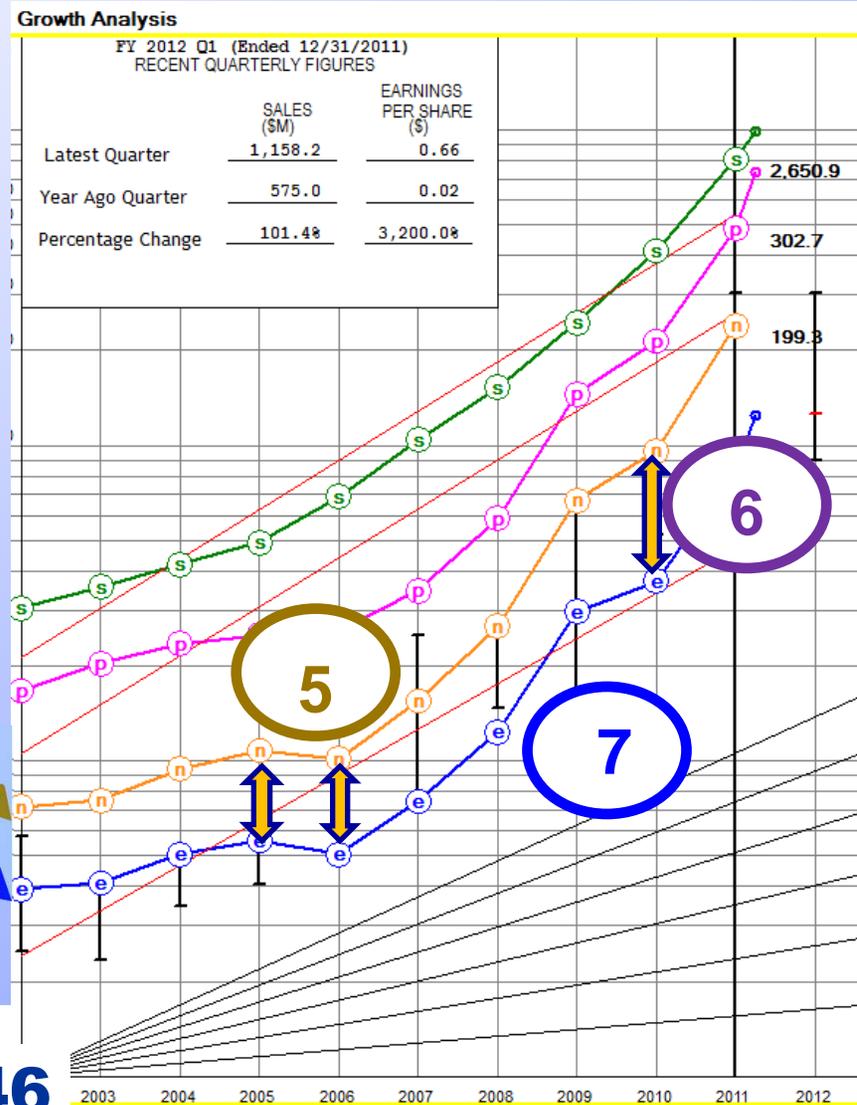
What is Happening?

The distance between the **Net Income** line and the **Earnings Per Share** line is changing. What might be the cause?

$$\text{Net income attributable to GMCR} \div \text{Diluted weighted average shares outstanding} = \text{Net income per common share—diluted}$$

Only one thing is happening in between!

Shares Outstanding !



Why Two Different Earnings Per Share?

Basic income per share:	
Basic weighted average shares outstanding . . .	146,214,860
Net income per common share—basic	\$ 1.36
Diluted income per share:	
Diluted weighted average shares outstanding .	152,142,434
Net income per common share—diluted	\$ 1.31



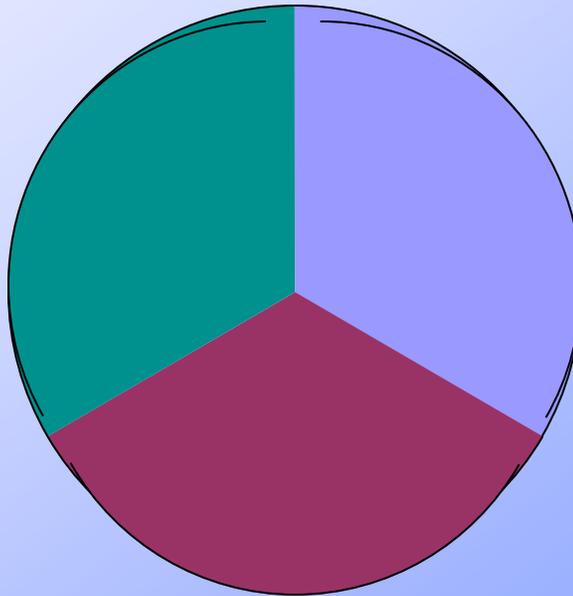
- What is the difference between **Diluted Earnings Per Share** and **Basic Earnings Per Share**?
- Which one do we use?

Dilution

- Dilution occurs when there are “**Dilutive Securities**”.
 - These are securities that:
 - Are not common stock.
 - Allow the owner to obtain common stock when they exercise an option or conversion privilege.
 - The most common are stock options, warrants, convertible debt or convertible preferred shares.
- The earnings of the company would be spread over more shares (diluted) if the **dilutive securities** were converted.

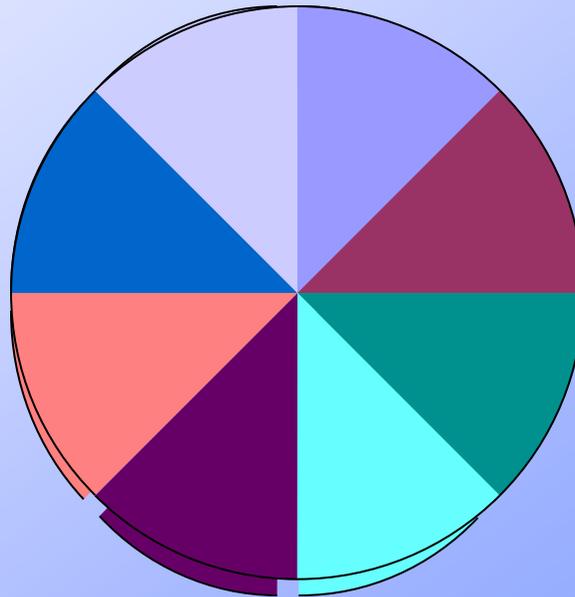
Why Do We Care?

If we have three shares outstanding, how big is every share?



Why Do We Care?

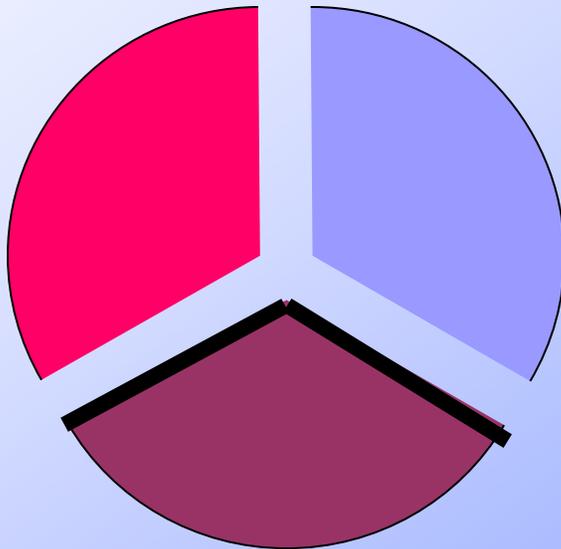
If we potentially have five more shares outstanding, how big is every share?



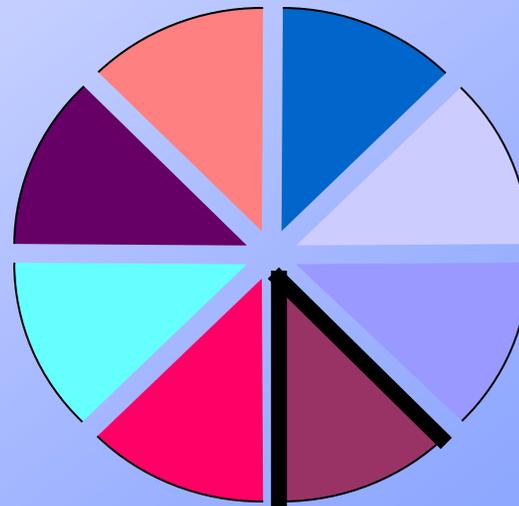
Why Do We Care?

Dilution reduces the size of our piece of the pie.

Before Dilution



After Dilution



Which Weighted Average Shares?

- We will use the **Diluted Weighted Average Shares Outstanding** !
 - Why?
 - Spreading the earnings over more shares gives us a lower, more conservative **Earnings Per Share**.
- **Note:** *In the calculation, any securities that would not be converted at the period end stock price are ignored.*

Questions?



Where Do We Go From Here ?



Reality Check

- We easily see what to focus on using Part 1 of the SSG, “Growth Analysis”.
 - The SSG tells you which items on the Income Statement to focus on.
 - We can isolate what is changing by looking at each set of lines.
 - This points us to the items we need to study and understand and consider in projecting the future.
 - Try looking in the Annual Report at Management’s Discussion and Analysis (MD&A).
 - We can then project our future **EPS** by evaluating each component of the preferred procedure.

EPS Five Years in the Future

 Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator

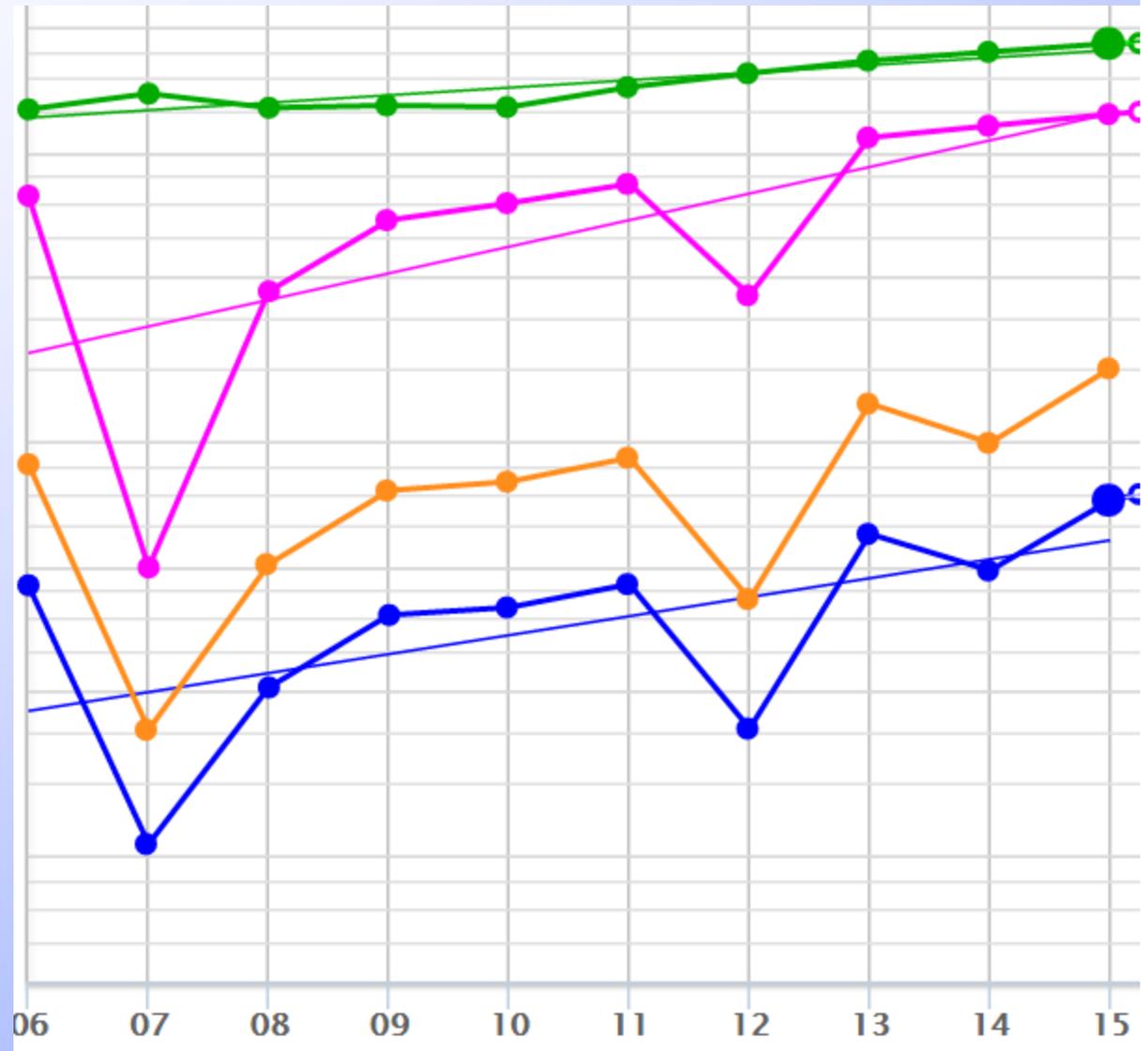
Preferred Procedure Calculation

Projected 5 Year Sales (G):	10.0%	<input checked="" type="checkbox"/>	<input type="text" value="10.0"/>	\$104,386.8
Less Expenses (Yr Avg % Pre Tax Profit Margin):	9.8%	<input checked="" type="checkbox"/>	<input type="text" value="11.2"/>	-92,695.5
Less Taxes (Last yr. Tax Rate):	37.1%	<input checked="" type="checkbox"/>	<input type="text" value="37.0"/>	-4,325.8
Less Preferred Dividends (Current Pref'd Div):	\$0.0	<input type="checkbox"/>	<input type="text" value="0.0"/>	0.0
Projected 5 Yr Total Earnings				= \$ 7,365.5
Divided by Shares Outs. (Current Sh's. Outs.(M)):	2235.0	<input checked="" type="checkbox"/>	<input type="text" value="2175.0"/>	<input type="text" value="3.39"/>

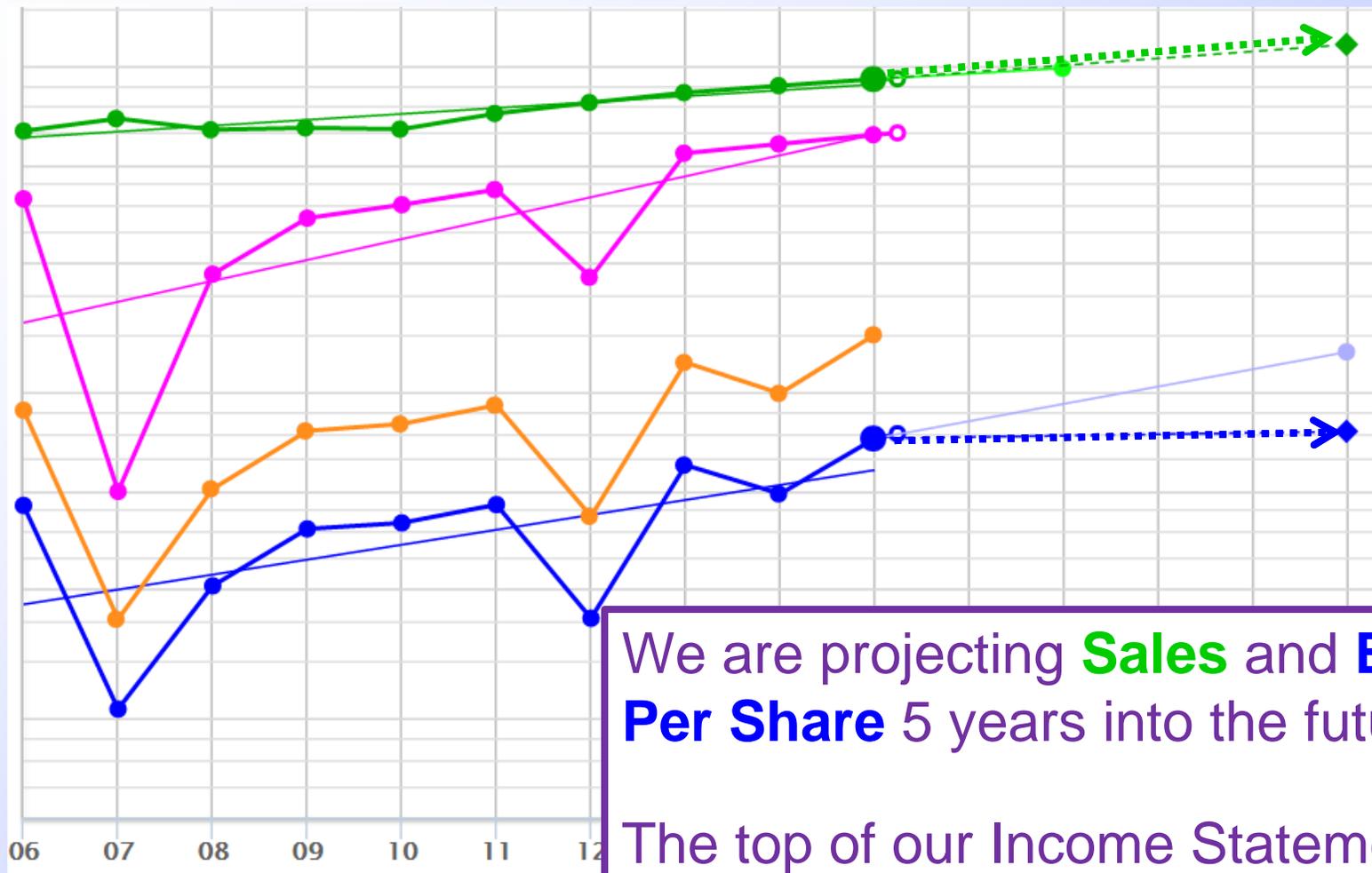
What They Don't Teach at BINC

BETTER INVESTING™
SSG PLUS

What are we trying to accomplish by using the SSG?



What They Don't Teach at BINIC

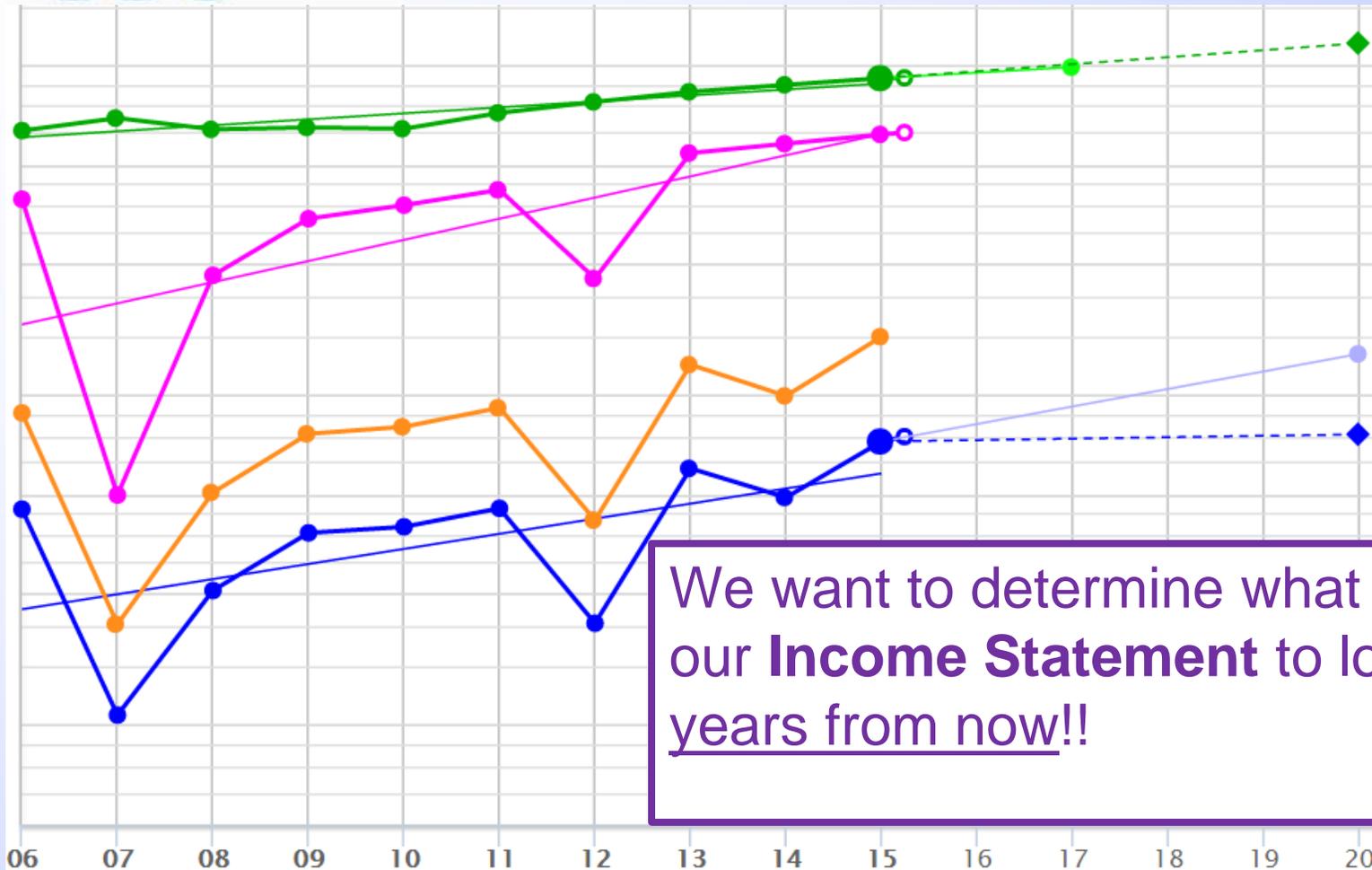


We are projecting **Sales** and **Earnings Per Share** 5 years into the future!

The top of our Income Statement (**Sales**) and the bottom (**Earnings Per Share**)

What They Don't Teach at BINC

BETTER INVESTING™
SSG PLUS



USING PREFERRED PROCEDURE – **WE CAN !**

How Do We Use This?

- We try to understand how the company has grown historically.
- We try to understand where things have changed over time:
 - **Sales**
 - **Expenses**
 - **Pre-Tax Profit**
 - **Taxes Paid**
 - **Net Income**
 - **Shares Outstanding**
 - **Earnings Per share**
- We use this information to help us project how the Income Statement might change over the next 5 years.

EPS Five Years in the Future

Our expected
Income Statement
5 years from now !

 Estimate Earnings per Share Growth Rate (Preferred Procedure Calculator

Preferred Procedure Calculation

Projected 5 Year Sales @:	10.0%	<input checked="" type="checkbox"/>	10.0	\$104,386.8
Less Expenses (5 Yr Avg % Pre Tax Profit Margin):	9.8%	<input checked="" type="checkbox"/>	11.2	-92,695.5
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What Do You Do with Preferred Dividends ?

- Preferred dividends must be paid to preferred shareholders before common shareholders get paid.
- To common shareholders, it is the equivalent of an expense.
- Estimate the preferred dividends five years in the future and subtract them from earnings before dividing by shares outstanding.

Summary

In this hour we've touched on:

- What preferred procedure is.
- The relationship of the Income Statement, the SSG and preferred procedure.
- Why we should use preferred procedure.
- Understanding the relationship between the lines on the SSG graph.
- Working with preferred dividends.

Special Thanks

Ron Bruyn, Director, Orange County Chapter

Linda Glein, Director, Puget Sound Chapter

Claire Struthers, Director, Heartland Chapter

Joe Smith, New Jersey

**THANK
YOU**

These are all special people whose work contributed to this session and who passed their knowledge of BetterInvesting methodology to me.

Thank you



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please pick up some

BETTERINVESTING

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and introduce others to this dynamic
investment education opportunity!

Pay it forward !

Questions or Comments?

