

Understanding Earnings Per Share (EPS)

By [Ken Little](#), About.com

One of the challenges of evaluating stocks is establishing an “apples to apples” comparison. What I mean by this is setting up a comparison that is meaningful so that the results help you make an investment decision.

Comparing the price of two stocks is meaningless as I point out in my article [“Why Per-Share Price is Not Important.”](#)¹ Similarly, comparing the earnings of one company to another really doesn’t make any sense, if you think about it. Using the raw numbers ignores the fact that the two companies undoubtedly have a different number of outstanding shares.

For example, companies A and B both earn \$100, but company A has 10 shares outstanding, while company B has 50 shares outstanding. Which company’s stock do you want to own?

It makes more sense to look at earnings per share (EPS) for use as a comparison tool. You calculate earnings per share by taking the net earnings and divide by the outstanding shares.

EPS = Net Earnings / Outstanding Shares

Using our example above, Company A had earnings of \$100 and 10 shares outstanding, which equals an EPS of 10 ($\$100 / 10 = 10$). Company B had earnings of \$100 and 50 shares outstanding, which equals an EPS of 2 ($\$100 / 50 = 2$).

So, you should go buy Company A with an EPS of 10, right? Maybe, but not just on the basis of its EPS. The EPS is helpful in comparing one company to another, assuming they are in the same industry, but it doesn’t tell you whether it’s a good stock to buy or what the market thinks of it. For that information, we need to look at some ratios.

Understanding Price to Earnings Ratio

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If there is one number that people look at than more any other it is the Price to Earnings Ratio (P/E). The P/E is one of those numbers that investors throw around with great authority as if it told the whole story. Of course, it doesn't tell the whole story (if it did, we wouldn't need all the other numbers.)

The P/E looks at the relationship between the stock price and the company's earnings. The P/E is the most popular metric of stock analysis, although it is far from the only one you should consider.

You calculate the P/E by taking the share price and dividing it by the company's [EPS](#).¹

P/E = Stock Price / EPS

For example, a company with a share price of \$40 and an EPS of 8 would have a P/E of 5 ($\$40 / 8 = 5$).

What does P/E tell you? The P/E gives you an idea of what the market is willing to pay for the company's earnings. The higher the P/E the more the market is willing to pay for the company's earnings. Some investors read a high P/E as an overpriced stock and that may be the case, however it can also indicate the market has high hopes for this stock's future and has bid up the price.

Conversely, a low P/E may indicate a "vote of no confidence" by the market or it could mean this is a sleeper that the market has overlooked. Known as value stocks, many investors made their fortunes spotting these "diamonds in the rough" before the rest of the market discovered their true worth.

What is the "right" P/E? There is no correct answer to this question, because part of the answer depends on your willingness to pay for earnings. The more you are willing to pay, which means you believe the company has good long term prospects over and above its current position, the higher the "right" P/E is for that particular stock in your decision-making process. Another investor may not see the same value and think your "right" P/E is all wrong.

Inquiry Chart

Industry	Stock	EPS	P/E Ratio
1.	a.		
	b.		
2.	a.		
	b.		
3.	a.		
	b.		
4.	a.		
	b.		
5.	a.		
	b.		

Questions

EPS

1. Describe what 'Earnings per Share' measures.
2. Explain what it means if a company has a low EPS. High EPS?
3. Based on EPS, which of your stocks is doing the best? Worst?
4. Based on EPS, which of the industries you invested in is doing the best? Worst?

P/E Ratio

5. What does the P/E Ratio measure?
6. Explain what it means if a company has a low P/E Ratio. High P/E Ratio?
7. Based on P/E Ratio, which of your stocks is doing the best? Worst?
8. Based on P/E Ratio, which of your industries is doing the best? Worst?