

Module 4 – Chapter 14 – Earnings Per Share (EPS)

Earnings Per Share (EPS) represents the portion of a company's profit that is allocated to each outstanding share of its common stock. It serves as an indicator of the company's profitability and is often used by investors to assess the company's financial health.

What it is and what it shows

EPS is calculated using the following formula:

$$\text{EPS} = (\text{Net Income} - \text{Preferred Dividends}) / \text{Average Outstanding Shares}$$

Where:

Net Income: This is the total profit of a company after all expenses and taxes.

Preferred Dividends: These are dividends that are paid out to preferred stockholders before any dividends are paid to common stockholders.

Average Outstanding Shares: This represents the average number of shares available over a particular period (often a fiscal quarter or year).

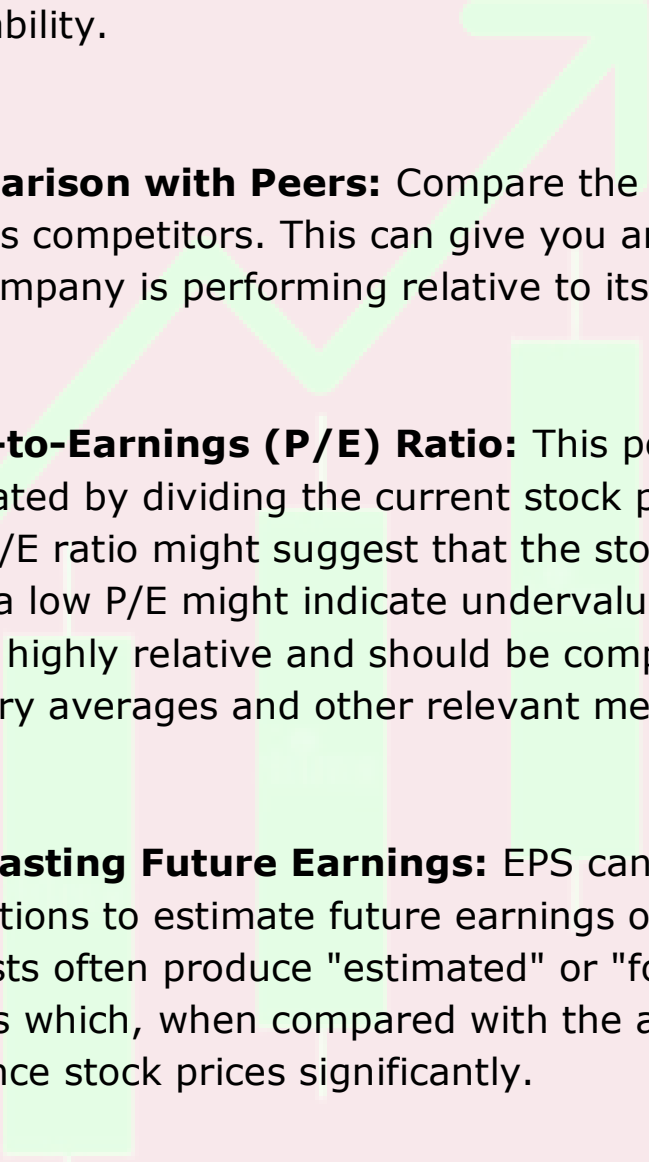
There are variations of EPS that investors might come across:

- 1) **Basic EPS:** Uses the formula above and is based on the actual number of outstanding shares.
- 2) **Diluted EPS:** Takes into account all convertible securities (like stock options) that could potentially be turned into common stock.

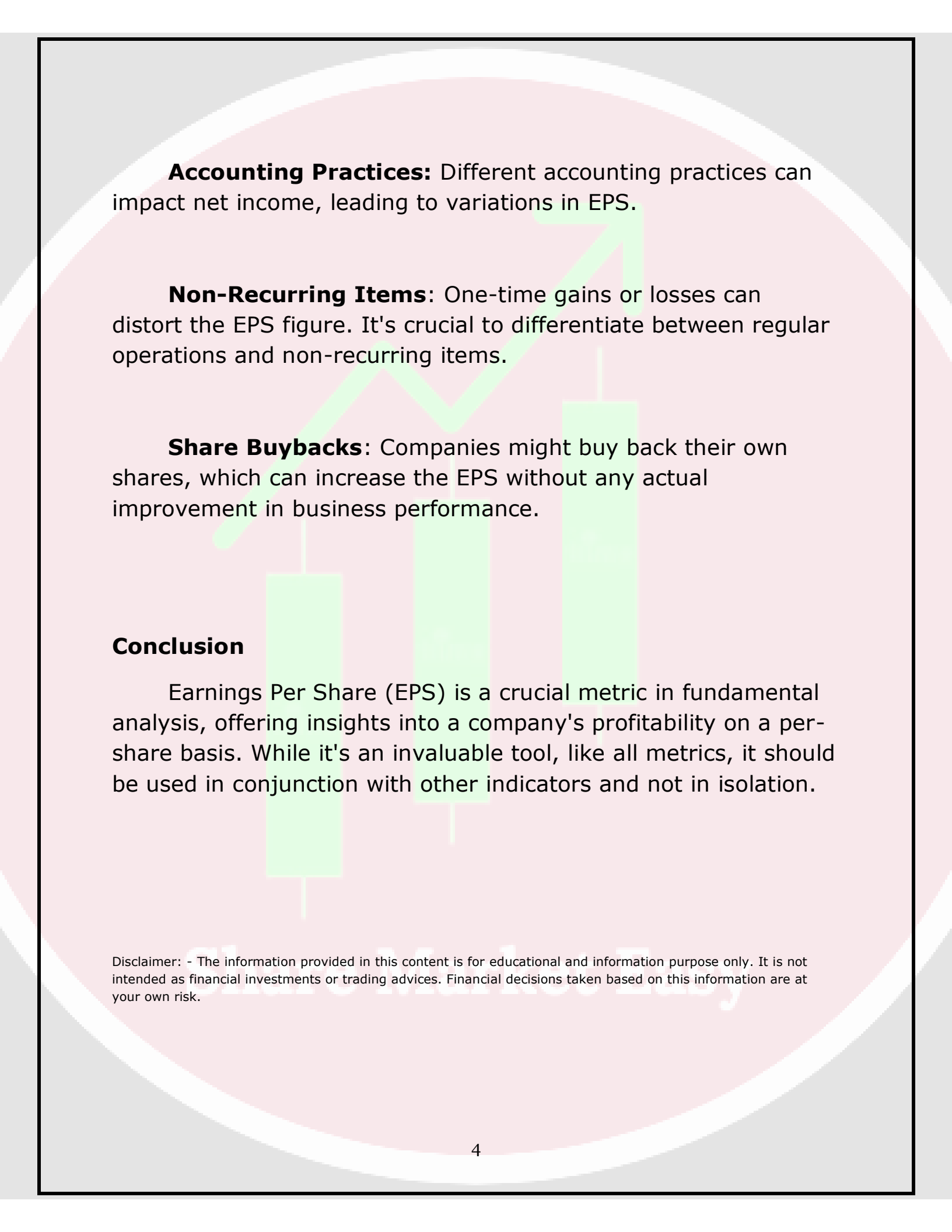
A higher EPS indicates more value, as there's more profit relative to the number of shares. However, this doesn't always mean the company is in a better financial position, which is why context and comparison are crucial.

How to use EPS in Analysis

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- 1) **Trend Analysis:** Look at a company's EPS over time. Is it increasing, decreasing, or staying relatively stable? An increasing EPS trend might suggest improving profitability.
 - 2) **Comparison with Peers:** Compare the company's EPS with its competitors. This can give you an idea of how well the company is performing relative to its industry.
 - 3) **Price-to-Earnings (P/E) Ratio:** This popular metric is calculated by dividing the current stock price by its EPS. A high P/E ratio might suggest that the stock is overvalued, while a low P/E might indicate undervaluation. However, this is highly relative and should be compared with industry averages and other relevant metrics.
 - 4) **Forecasting Future Earnings:** EPS can be used in projections to estimate future earnings of the company. Analysts often produce "estimated" or "forecasted" EPS figures which, when compared with the actual EPS, can influence stock prices significantly.
 - 5) **Dividend Considerations:** Companies with a higher EPS might have more room to increase their dividends in the future, assuming they distribute dividends to shareholders.

Limitations of EPS



Accounting Practices: Different accounting practices can impact net income, leading to variations in EPS.

Non-Recurring Items: One-time gains or losses can distort the EPS figure. It's crucial to differentiate between regular operations and non-recurring items.

Share Buybacks: Companies might buy back their own shares, which can increase the EPS without any actual improvement in business performance.

Conclusion

Earnings Per Share (EPS) is a crucial metric in fundamental analysis, offering insights into a company's profitability on a per-share basis. While it's an invaluable tool, like all metrics, it should be used in conjunction with other indicators and not in isolation.

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