WealthCE

Earnings Per Share

“Earnings per Share” is a measure of the profitability of a firm or company. EPS is simply net income divided by the number of common shares outstanding, released, or issued. Since it’s divided by the number of shares issued, it is easily changed and usually is not constant year over year. It’s also meaningless without looking at several other factors in the stock, including cash flow.

Earnings Per Share = Net Income / Number of Shares Issued

EPS is usually found in reports issued by firms themselves, usually within a note by share movements. These can be misleading depending on how the firm calculated its EPS. You should take the time to determine how exactly it was calculated or derived. This given number also prevents firm to firm comparisons, as differing firms may have calculated their EPS in differing ways. Net Income may be affected by any number of decisions within the income statement which modifies EPS. It’s best for you to find their own EPS values when comparing between firms.

EPS has many conceptual problems which can misdirect you when comparing and contrasting separate firms. These include Share Distortion, One Gains or Losses, Capital Structure, and potential Dilution of EPS.

Share Distortion is a problem with Earnings per Share that changes EPS year over year. Since Net Income is divided by number of shares issued, any increase in shares will decrease EPS, and any decrease in shares will increase EPS. If firms simply buy back shares on the market their EPS will increase. If options are exercised or sold to the marketplace from Treasury Shares, both of which allow additional shares onto the market, EPS will decrease. Options also play heavily into this issue. Options which have yet to be converted (but could be) can increase shares and decrease EPS. This is normally represented in a version of the EPS called “Diluted EPS”. The diluted EPS assumes that all options have been exercised, but may include only those options within a price range. The options not included may be extremely diluting, even though they are not shown. Because of these factors EPS is inconsistent year over year unless the firm has the same number of shares on the market, you should be sure to check the shares outstanding when judging EPS.

Firms are not distorted only by shares increasing or decreasing. They are also distorted by changes in the actual earnings, regardless if these changes are genuine increases or 1 time after-effects. EPS can be dramatically altered based on asset sales from selling off a division or subsidiary or writing down an asset which turned out to be a loss. Any 1 time change, positive or negative, can skew EPS. It’s sometimes better to calculate what EPS would or could be if they were canceled out so EPS is from actual operations.

When comparing multiple firms, you need to be aware that any capital differences between firms will result in EPS being incomparable. Two firms with precisely the same net earnings can have drastically different EPS due to different shares outstanding. A firm with 500 shares outstanding will have higher EPS than a firm with 20,000 shares outstanding even if they have the same Net Income. It is only helpful to compare the percentage growth of Earnings per Share in this case. The last potential problem with EPS is that it does not properly represent a firm’s debt levels. Even if one-time gains, dilutions, and share distortions were equal the earnings created by the firm may have been heavily leveraged. Two firms with the same EPS may be drastically different in risk since one is highly leveraged for achieving the result and the other has little to no debt. For this reason EPS should be an indicator of potentially powerful firms, but only after substantial investigation of a firm’s leverage.