

CONCEPT: RATIOS – PRICE-EARNINGS (P/E) RATIO

- The **price-earnings (P/E) ratio** analyzes the relationship between the stock's market price and earnings per share.

- ☐ P/E ratio is a common _____ ratio
- ☐ Earnings per Share (EPS) is an integral part of this ratio, we will review it here:

$$EPS = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average \# of Shares of Common Stock Outstanding}} = \frac{\text{Net Income} - \text{Preferred Dividends}}{(\text{Beg. \# of Shares} + \text{End. \# of Shares}) \div 2}$$

$$\text{Price Earnings Ratio} = \frac{\text{Current Market Price for a Share of Common Stock}}{EPS}$$

Note: An average balance is used in many ratios. It is always calculated as _____.
If you are only given one balance (i.e. ending balance), just use that number (no average!)

Analysis: This ratio shows the market price for \$1 of earnings for the company.

Comparison: Investors want to pay as little as possible for as much earnings.
However, high P/E ratios could indicate high projections for future earnings.

PRACTICE: MoneyCo had sales revenue and net income during the current year of \$500,000 and \$60,000, respectively. The total amount of stockholders' equity was \$600,000, and common shares outstanding were 120,000 all year. If the market price of the stock is \$10, what is the P/E ratio?

- a) 5
- b) 10
- c) 20
- d) 40

PRACTICE: Tougher Company's current year income statement showed an EPS of \$1.25 per share. If total common equity totaled \$600,000 (40,000 common shares), preferred dividends were \$10,000 (10,000 preferred shares), and the market price of common and preferred stock are \$25 and \$50, respectively, what is the company's P/E ratio?

- a) 5
- b) 10
- c) 20
- d) 40