

Taking the Spin Out of Earnings Announcements

By CFA Institute

Public companies always want to put the best face on their quarterly financial results—that's just human nature.

But it doesn't mean an investor needs to be distracted by excessive 'spin' or downplaying of less favorable information that may in fact be critical to seeing the complete picture.

While the SEC filings (called 10-Qs for quarterly reports and 10-Ks for annual financial filings) are mandatory and there are specific rules about what must be reported in them, news releases are not mandated by law. In fact, companies have a great deal more flexibility about what they disclose in their earnings press releases. For this reason, investors should be cautious of earnings news releases that typically precede the financial reports filed with the Securities and Exchange Commission.

Consider this extreme example: Among the 30 companies that make up the Dow Jones industrial average,

- Just over one-third of the companies do not issue a balance sheet along with their income statements when they issue their earnings news releases, and
- Almost half do not issue a cash flow statement until later.

Analysts consider the three financial statements—the balance sheet, income statement and cash flow statement—taken together to be critical in gaining an accurate picture of a company's position. But too often they have to wait until weeks after the company's earnings announcements, when the companies file their 10-Ks or 10-Qs, to look at the other two financial statements. By then, the announcements are under the radar screen of most media.

Here are some tips to keep in mind when reviewing earnings announcements.

Do Your Homework

Investors will find that reviewing a company's 10-K and 10-Q filings will provide a more complete picture than the earnings releases alone. These filings may be found on a company's own Web site or in the SEC's EDGAR database (www.sec.gov/edgar.shtml).

You should focus in particular on the sections of these reports that contain discussion of risk factors and market conditions. When the company issues its quarterly release, be on the lookout for any mention of these factors in the earnings press release.

You should also review past earnings announcements, which can often be found in a company's on-line press room or the investor relations section of its Web site. Usually, past analyst conference calls are also archived on the investor relations page.

Read With Healthy Skepticism

Earnings press releases often frame a company's quarterly performance in a way that may make the results appear more positive than they really are. You should question why companies are emphasizing certain numbers and not others. For instance, they may be boasting about record sales volume to distract from the fact that they also had record expenses and lower net income. Or, they may emphasize a non-GAAP (generally accepted accounting principles) number, such as earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA), because the actual net income isn't strong.

Focus on the "Real" News

Read the news release for background and context, but read the financial statements for the "real" news. The income statement and sometimes other "financial highlights" are typically included at the bottom of the press release—that's where the real story is.

The text of the news release can be window dressing. At best, it provides helpful commentary and insight. At worst, it's a distraction. Either way, it's the financial statements themselves that really matter.

If a company doesn't issue a balance sheet and cash flow statement with its earnings announcement, you'll need to come back later, after it has filed with the SEC, and look at the three statements together to get the most complete picture. In particular, be on the lookout for earnings and cash flow figures that are not in sync. If cash flow from operations lags behind net income, this could mean that future earnings will be poor.

Don't Focus Only on Net Income

Recognize that net income isn't the only bottom line. Earnings announcements focus on net income—the "bottom line" that investors and pundits typically look for in keeping their quarterly scorecards of corporate performance. And it is, of course, a key measurement.

But net income can be more easily manipulated than many people realize. Companies have been known to recognize as revenue "sales" that haven't technically closed yet. Others have been known to hide actual expenses, sometimes by (mis)treating them as capital investments, thus spreading out their effects on the financial statements over many years, rather than taking a one-time hit. The end result may be "managed earnings"—reported earnings that have been massaged to be more in line with investor expectations. For these and other reasons, most analysts consider a company's cash flow to be a better indicator of financial strength than net income. Cash flow can reveal strengths or weaknesses that aren't going to show up on the income statement. Plus, it is much harder to manipulate the report of cash flow versus income. A cash flow statement is a little like your monthly bank statement. It's difficult to fudge what's going in and going out.

Put the Numbers in Context

Earnings by themselves for a particular quarter don't necessarily reveal much without considering how they compare to previous quarters and also to the performance of the company's competitors.

Corporate news releases are generally good about comparing current-year results with the prior year or current-quarter results with the same quarter a year ago (generally a better comparison than quarter-to-quarter changes because of seasonal fluctuations).

But to look at the bigger picture, most analysts want to compare the current quarter with at least the prior 12 quarters. You can do that by going either to the company's Web site, where its past press releases and financial filings should be posted, or by going to the SEC Web site.

To aid their sleuthing, most analysts convert the whole numbers in the income statement into percentages, with each line item represented as a percentage of revenue. This is called a common-size income statement, and it greatly simplifies quarter-to-quarter and year-to-year comparisons of earnings results. You may find, for instance, that while a company may be touting record sales, its net income this year is 5% of revenue compared to 10% of revenue last year.

Look at the Competition

Investors should also compare earnings with other companies in the same industry to help gauge performance across the entire peer group of companies.

Unless you have a specific benchmark such as industry-specific metrics to compare, how can you tell whether a company is successful? Also be sure to go back historically if there have been many changes in management.

To make performance comparisons across companies, analysts look at key margins, or ratios. Margins measure, for instance, how much is left over from sales after expenses have been deducted. Margins can be used both to compare profitability among many companies and to make investors aware of financial trouble. Growing or shrinking margins tell a lot about a company's future earnings potential.

Gross profit margin, operating profit margin and net profit margin are all important metrics to consider. Trends are as important, if not more important, than absolute numbers. To understand trends, you need to understand the industry that the company is in.

Beware of "One-Time Charges"

Although one-time charges or extraordinary items are supposed to represent expenses that are unlikely to occur again regularly in the future, be wary.

Sometimes a company may try to hide a larger expense or loss from investors by claiming it as a one-time charge. An incomplete or vague explanation of the charges could be a sign of more troubling or unexpected disclosures to come. Be particularly wary of companies that regularly report various and sundry one-time charges. If, in the aggregate, a company consistently reports different one-time charges, that is a strong signal that earnings quality could be poor.

Beating Estimates: No Big Deal

Don't be unduly impressed with companies beating analysts' estimates.

While news reports often emphasize that companies' announced earnings beat analyst estimates by a penny or two a share, this isn't anything new. Companies almost always beat their estimates. This is because companies are careful to set expectations in their public statements during the quarter that are just slightly below what they know they will be able to deliver.

It's also partly due to a frequent "herd effect" among analysts, who don't want their quarterly forecasts to be too far above or below the average of their peers.

The Bottom Line

If all of this analysis seems like a lot of work, remember that when you buy stocks, you are buying a business, not a piece of paper, so you have to do your due diligence.

Key Definitions

Operating Results: Defined as operating profits, it represents how a business did in terms of sales, minus all incurred expenses. It is a measurement of profits produced before interest and taxes.

Comparable Sales: Comparing sales of the current quarter versus the same quarter one year prior.

Improved Margins: When profitability has improved over the previous year's sales. Essentially, margins are a measurement of how much is left over from your sales after expenses have been deducted.

Constant Currencies: If companies incur revenue from outside the U.S., the revenue is based on local currency, but currency rates change every year. By keeping currency rates "constant" or the same from the previous year, one can measure same-store sales growth (growth without acquisitions or new store openings) without the effects of the exchange rate—which can be volatile at times and impact the "true" profitability growth.

System-Wide Sales: How much the company made overall in all of its stores—both company-owned and franchised.

Earnings per Share: Net income divided by the number of shares still outstanding being traded in the marketplace.

Diluted Earnings per Share: Net income divided by the number of shares still outstanding being traded in the marketplace, but includes the effects of stock options as if they were converted to shares.

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