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Earnings Call: A Closer Look at Financial Reports

See disclaimer on final page Finn The second quarter of 2016 marked the fifth quarter in a row of declining U.S. corporate earnings. Low oil prices and a strong dollar were largely to blame for lackluster financial results.[1]

Publicly traded companies are required to report quarterly financial results to regulators and shareholders. Earnings season is the often-turbulent period when most companies must disclose their successes and failures.

An earnings surprise--whether profits come in above or below the stock market's expectations--can have an immediate effect on a company's stock price, so it's easy to understand why executives may go to great lengths to impress their investors. Earnings do represent a corporation's bottom line and are generally a key driver of the stock price over time. Still, an earnings surprise may not be a reliable indicator of a company's longer-term outlook, partly because earnings figures generally reflect past performance.

Earnings are just one factor to consider when evaluating a company's outlook. Sales performance, research and development, new products, consumer trends, and global economic conditions can all affect future results.

Performance watchwords

A quarterly report typically includes unaudited financial statements, a discussion of the business conditions that affected financial results, and some guidance about how the company expects to perform in the following quarters. Financial statements reveal the quarter's profit or net income, which must be calculated according to generally accepted accounting principles (GAAP). This typically involves subtracting operating expenses (including depreciation, taxes, and other expenses) from net income.

Earnings per share (EPS) represents the portion of total profit that applies to each outstanding share of company stock. EPS is the figure that often makes headlines, because the financial media tend to focus on whether companies meet, beat, or fall short of the consensus estimate of Wall Street analysts. A company can beat the market by losing less money than expected, or can log billions in profits and still disappoint investors who were counting on more.

To help avoid surprises, many companies take steps to manage the market's expectations. For example, they may issue profit warnings or revise previous forecasts, prompting analysts to adjust their estimates accordingly. Companies may also be able to time certain business moves to help meet earnings targets.

Shaping perception

In addition to filing regulatory paperwork, many companies announce their results through press releases, conference calls, and/or webinars so they can try to influence how the information is judged by investors, analysts, financial media, and the general public.

Pro-forma (or adjusted) earnings may present an alternative view of financial performance by excluding nonrecurring expenses such as restructuring costs, interest payments, taxes, and other unique events. Although the Securities and Exchange Commission has rules governing pro-forma financial statements, companies still have a great deal of leeway to highlight the positive and minimize the negative in these reports. There may be a vast difference between pro-forma earnings and those calculated according to GAAP.

The media hype surrounding earnings that come in stronger or weaker than expected could distract from other important details that may be included in a company's quarterly report. Understanding the reporting process may help you ignore short-term market swings and remain focused on your long-term investing strategy.

Note: The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost.

1 FactSet, 2016