Here's What's Important About Earnings Reports

Part of the process of evaluating the underpinnings of stocks is the information companies report during what's known as earnings season. For companies reporting their quarterly results on a calendar-year basis (most do), there are four key reporting periods: late January/early February; late April/early May; late July/early August; and late October/early November. These are known as the earnings seasons.

Earnings seasons are when companies tell the public how they are doing. These are the times stocks when tend to be most volatile, occasionally due to results that are better or worse than what was expected. But let's not get ahead of ourselves.

The focal point of earnings reports is the bottom line: Did the company do better and by how much? Or vice-versa? The response to that barely scratches the surface of what investors need to know, but in most cases the formula for a proper assessment is not that complicated.

Here's the pecking order of how reports work: If both revenues and earnings are rising, that's the most promising combination. If earnings are rising, but revenues are not, that will raise the caution flag.

Rising earnings without a proportionate gain in revenues can mean a number of things. First, costs are being cut, which raises margins as well as profits. Even so, from a long-term standpoint, that approach cannot inspire confidence in long-term prospects. A second explanation is that the number of shares outstanding has been reduced by buybacks, so here, too, the apparent gain is largely artificial. Finally, earnings may have been boosted by a one-time gain such as a sale of assets. What investors insist upon is sustainable earning power. The hitch is that nonrecurring items do not support long-term growth. Bottom line: Both indicators must be pointing higher.

Rising revenues accompanied by lower earnings may or may not be a problematical indication. Sometimes, this apparent mismatch may be the result of a product introduction and heavy marketing expenses to support the debut. As time passes, this may translate into a resumption of earnings growth. But not always.

When both revenues and earnings are heading south, that can be ominous. If it continues, it would mean a company whose products or services have no longer kept up with the changing marketplace.

There's more. When quarterly reports are released, it's common for companies to issue guidance on what lies ahead. If future guidance is raised, that's a good sign, often likely to boost stock prices. Whatever the case, any changes in what's to come will be scrutinized by Wall Street.

And then there's the matter of the whisper numbers. These are the estimates that are talked about by industry professionals based upon their own research. Sometimes they are significantly different from what the companies provide as guidance. When the actuals don't come up to the level of the whisper numbers it should come as no surprise that the shortfall will end up as a dip or plunge in the price of the stock.

So when reading what companies have to let us know about how they are doing, use this information as a yardstick to get a better handle on where they really stand.