Making sense of the reporting season

By Michael Kemp

The 2001 collapse of Enron, previously a darling of the US stock market, saw investors lose a combined US$11 billion. The chilling story was extraordinary since the preceding 15 months had seen Enron's share price peak at US$90 and Fortune Magazine award it America's most innovative company for sixth year running. The reality was Enron had been balance sheet insolvent for some time, but you wouldn't have known that from picking up the annual report. It was a wake-up call to all investors. Accepting financial statements at face value can be a wealth-hazard.

The Enron Scandal involved fraud, which isn't the subject of this article. But it is a reminder that financial statements are accounting constructs. Sure, they are controlled to some degree by generally accepted accounting principles, but they still remain constructs. And for that reason they require interpretation.

This article focuses on the income statement, that page in the annual report investors usually flick to first. Fair enough, since perceptions of future earnings shape our current valuation decisions. And in the absence of a crystal ball we turn to reported earnings as a guide to what the future might hold. But there are two main areas where the income statement can let us down. The first is how income and expenses are classified. And the second is how they are timed. That is, in what period they are actually reported? Which all means the net profit figure can become skewed from economic reality. There are many ways this can occur, so I won't attempt to cover them all. However, a couple of examples are in order: the reporting of significant items and depreciation.

Significant items

You will sometimes see expense items reported as "significant" and distinguished from normal operating expenses. Significant items can be defined as those which have a material impact on earnings and are not expected to recur. The purpose of separating them out is to see what profit the company would have achieved had they not occurred, which is referred to as "underlying earnings". If investors believe the one-off story they are more likely to use underlying earnings as an indicator of future profitability. So when you see a significant item(s) in the financial statements ask the following questions: Firstly, does the company have a habit of reporting them? If so, then maybe they shouldn't be classified as significant items, but rather be included in a company's normal operating costs. Secondly, if this is the first time you have noticed the item, ask whether the company has a deteriorating business model. If so, then maybe there will be more "significant items" in the future. The current one might just be the canary in the coal mine. However, if you believe the reported item to be a genuine one-off cost, then treat it as such. And if the share price is sold down on the news you might be presented with a buying opportunity.

Depreciation

The Income Statement shows the revenue achieved and expenses incurred over the course of the financial year. However, the trigger for their recognition in the accounts is not simply when cash is received or spent; which means these figures don't accurately reflect the real cash flows of the period. One example is how "depreciation expense" is reported. Companies need to undertake ongoing expenditure to maintain their businesses (termed Capital Expenditure or Capex). Planes for Qantas, warehouse capability for Metcash, port facilities for Asciano. Failure to maintain equipment means a business is going backwards, but ironically it often means the company can overstate earnings; for a while at least.

From an investor's perspective an appropriate figure to report would be the Capex required to leave the company in the same productive shape at the end of the year as it began. Instead companies use an accounting construct called depreciation. Depreciation is calculated by allocating a proportion of the original purchase price of the equipment as a cost to each year it remains in service. It usually understates the true cost of maintaining operational capability in any given year. If you want to see how much the company actually did spend on Capex for the past year this is listed in the Cash Flow Statement.

Using the cash flow statement to check the income statement

The Cash Flow Statement can be used as a check on the Income Statement. It is less subject to timing and classification distortions, because it records actual cash flows in and out of the business during the year.

To do this look part way down the Cash Flow Statement for the total given as "Net Cash flows from Operating Activities". This is like a cash-based profit figure. However, it doesn't include the amount spent on new equipment. That cost is found as a separate item further down the page called "purchase of property, plant and equipment". Deduct this from the net cash flows from operating activities to derive a figure referred to as free cash flow. Compare this to reported net profit after tax. If they are close you can gain a degree of comfort in the reported net profit figure. If not, ask why. There can be legitimate reasons for the difference, but a significant difference warrants investigation. Unfortunately, an explanation of the reasons is beyond the limits of this article.

Continuous disclosure

The Australian Securities Exchange aims to maintain fairness and efficiency in the operation of financial markets. The timely dissemination of price sensitive information is an important part of meeting these requirements. To facilitate this, ASX Listing Rule 3.1 on Continuous Disclosure states:

"Once an entity becomes aware of any information that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell the ASX that information."

In other words companies are required to issue statements declaring price sensitive information as it comes to hand not just via the annual or half-yearly reports. Investors should check regularly for these. They can be accessed through the ASX website or through the "Announcements" link on your broker's website.

Earnings guidance

Companies periodically announce their expectations of soon to be reported earnings figures. Referred to as earnings guidance, this requirement is governed by the continuous disclosure requirements. But how large does a variation need to be before a company has to disclose it? Exact parameters aren't stipulated. However, ASX Guidance Note 8 helps us interpret the requirements. It suggests:

"As a general policy, a variation in excess of 10% to 15% may be considered material, and should be announced by the entity as soon as the entity becomes aware of the variation."

Earnings forecasts

Despite continuous disclosure requirements, the reporting season can still produce surprises. These often see a significant move in the share price of the company. Moves can on occasions appear to be counterintuitive. For example, a company reporting a record profit might be sold off, or a company reporting poor earnings can see its share price rally. This is because share prices live and die on expectations. So, if a company reports a record profit, but it falls short of analysts' forecasts the share price might drop. Equally, a poor result might see a company's share price rally if an atrocious result was expected.

Earnings forecasts can usually be accessed via your broker's website. For Commsec users: click on "Company Research" and then the "Forecasts" tag. This will also tell you whether the company has a history of surprising the market. Other commonly accessed sites are E*Trade and Yahoo Finance.

I hope the coming reporting season is kind to you!

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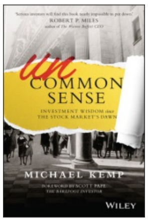

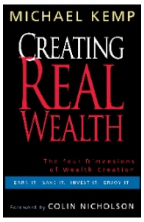

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.