Why Investors Should Ignore Adjusted Earnings

Description

When companies release earnings reports, investors are typically looking at a company's sales and profitability; however, the problem is that the most important information is often found between those two line items.

This is especially true when looking at profitability; companies are normally evaluated based on adjusted earnings numbers, which exclude one-time expenses and costs relating to acquisitions.

Why adjusted earnings does not add value and could indeed hurt investors

Warren Buffett is not a fan of adjusted earnings; he believes that while it's important for management to communicate abnormalities in the management discussion and analysis (MD&A), net income shouldn't need adjusting. After all, companies that are routinely involved in acquisitions or have gains or losses could always see big fluctuations between accounting income and adjusted income.

It also encourages management to dump as many costs as possible into acquisition-related expenses or other line items that will be discounted from a company's adjusted earnings, which will be compared against analysts' expectations. This can create a great deal of earnings management and allow companies to find ways to meet expectations.

Adjusted earnings is also a non-GAAP calculation, which allows for bias and subjectivity when determining whether something should be included in the total.

Why it's fine for earnings to fluctuate

The purpose of adjusted earnings is to normalize a company's bottom line and take out nonrecurring items. However, that's the whole purpose behind a company explaining variances in the MD&A to give investors more context behind the results and understand why the results may be significantly different.

Adjusted earnings simply offers investors an easy way to skip over reading the financials and instead encourages them to rely on a number that can prove to be very unreliable.

Recently, we saw **Royal Bank of Canada** (TSX:RY)(NYSE:RY) see tax reforms in the U.S. result in a softer bottom line after revaluations eroded some of the bank's profits. **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) saw a similar impact on its financials after what was otherwise a strong quarter.

Although one-time expenses like this can skew a bank's results, the abnormalities can quickly and easily be explained and even seen on the financials. By using adjusted earnings, however, it gives managers too much ability to influence the numbers. Thus, working to ensure that expectations are met becomes an exercise in finding as many expenses as possible to bury in items that will be eliminated from its calculation.

Takeaway for investors

With so many items potentially impacting a company’s earnings, investors need to carefully review financial statements and avoid relying on adjusted numbers and calculations. The line item I find most useful is operating income, as it’s a GAAP figure that will take into account relevant revenues and expenses that are related to a company’s operations, which won’t be skewed by gains, losses, or other non-operational line items.

There are no shortcuts to due diligence. If you’re planning to invest in a company, you should take a close look at its financials to determine how it’s doing rather than relying on adjusted numbers.

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