Earnings Season Is Here: 3 Things to Look for When Companies Report

Description

As many companies go to report their earnings over the next several weeks, investors will be on the lookout for which stocks are primed to increase as a result of strong performances and which ones to avoid.

The problem is that there's often a lot of noise when it comes to reading earnings reports, and it's easy to focus on just sales and profitability. There are many items that can skew the numbers and undermine their value for investors, and sometimes that gets lost in translation.

Below are three items I'd suggest investors look at when evaluating a company's earnings that can help uncover any issues.

Organic sales growth

Sales growth on its own is not impressive. Opening more locations and raising prices are just a couple of ways for companies to increase their sales without actually showing an improvement from the prior year. While adding locations is definitely a good indicator of operational growth, it doesn't suggest the company is offering better products and services.

For companies that have physical storefronts, you'll want to look at same-store sales growth, as that will give you an indicator of how well the store has grown from a year ago and whether it is generating more revenue. Traffic and volume numbers are also good indicators of whether more people are coming through the doors or if the company is just benefiting from higher prices.

Increasing sales by increasing prices or adding locations is simply not sustainable and could even backfire with more overhead and a less-competitive product.

Operating income

I've looked at a lot of earnings reports, and the two places where you can see a lot of noise is at thetop and at the bottom. Operating income falls nicely in the middle and can give you a clear picture ofwhere the company is from an operational perspective and before adjustments and one-off items.

A good example of this is **Aphria** (TSX:APH), which recently reported its earnings. Not only did the company see a lot of noise in its gross profit section with revaluation gains, but its net income was boosted by investment-related gains that had nothing to do with the company's day-to-day operations. While Aphria posted a positive net income figure, its operating income was in the negative.

If a company needs other items or investments to keep it out of the red, then that should be a warning sign for investors.

Free cash flow

The statement of cash flow is probably the most important financial statement investors can use. Cash is ultimately what keeps the lights on and is even more important than turning a profit. Net income is an accounting term and includes non-cash items that offer no indication of how a company's day-to-day operations are doing.

By factoring out capital expenditures, free cash gives you a good picture of where the company is after paying all its bills. A company that isn't generating free cash flow is one that will need to borrow or issue shares, and that could cause issues down the road.

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Date
2025/08/27
Date Created
2018/10/28
Author
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