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Time for the corporate report card

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It has already started in the US, and the next five weeks will see the reporting season hit its stride in New Zealand and Australia. While reporting season is big news for those of us in the investment industry, most people only become aware of it when a newspaper headline highlights a rise or fall in the profits of a high-profile company.

This reporting season will be more interesting than most, because as companies in different countries and different sectors announce their profit results in the weeks ahead, many of us will be poring through the management commentaries for some pointers as to how the year ahead might unfold.

You see, profit results are not just about the profit numbers. What really gets analysts interested is the accompanying management comments that let you know how the company is faring right now, and what might be on the immediate horizon. Management knows their business better than the rest of us, and will have more information than us about whether customers are starting to buy again, or whether they are winning business at the expense of their competitors.

In the past, analysts could speak to chief executives whenever they liked and get a feeling for how a company's profitability was tracking. However, this practise led to some investors getting an unfair advantage over others, so legislation was enacted some years ago whereby companies are now required to broadcast their expectations to everybody at the same time, so all investors have an opportunity to assess the information.

Earnings guidance is defined as the comments that management makes about what they expect their company to do in the future, also known as 'forward looking statements'. These comments often focus on sales or profit expectations in light of the current industry and economic trends.

As the recession has unfolded, fewer companies have been prepared to provide earnings guidance, because they haven't wanted to be punished for falling short of expectations. In a market where a company's share price can fall 30% because its profits are 5% less than expected, what chief executive is going to want to make a forecast? Rather, management teams are increasingly leaving out the profit forecast numbers and simply giving a business update which analysts can then use, in combination with their own research, to develop profit forecasts.

The effect of this can be a wider range of analyst forecasts, and a greater range of opinions – without the 'anchor' profit forecast provided by the company, analysts use their own interpretation of information to decide whether a company is a 'buy' or a 'sell'.

This is why the reporting season is important – in coming weeks, analysts are going to be looking at the profit numbers, reading the management commentaries, and re-setting their profit forecasts for the year ahead. Profits are a key determinant of what a company's share price is worth. Company profit results that are better than expected can highlight shares that are undervalued. Of course, we can't forget that the reverse is true too.

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