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Are Profits Surging or Flat? It Depends

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The second-quarter reporting season is just about over, with 456 of the companies in the Standard & Poor's 500-stock index having announced profits or losses.

But interpreting the results is not easy, which makes it hard to judge the health of corporate America.

You can argue that second-quarter earnings rebounded strongly. Or you can claim that earnings barely bounced back.

According to operating earnings gathered so far and adjusted by Standard & Poor's, second-quarter profits jumped 29.7 percent, compared with the second quarter of 2001. But Thompson First Call, which collects earnings as calculated by Wall Street analysts, says that profits grew 0.9 percent.

Both second-quarter tabulations break a string of five consecutive quarterly declines. Otherwise, interpretations vary widely. Bruce Steinberg, Merrill Lynch's chief economist, said that "a powerful earnings recovery is now under way," citing the second-quarter profit surge in the S.& P. data. Thomas McManus, equity strategist at Banc of America Securities, said First Call's 0.9 percent gain in profits "is minuscule, indicating that, at best, we are bouncing along the bottom in terms of profits."

The truth is somewhere in between, but the tabulations don't help you figure where.

One culprit for this confusion is corporate America, which went on an orgy of one-time writeoffs and pro forma obfuscation in the second quarter of 2001. But there is also a problem with the gatherers of the earnings numbers, who use methods that understate or overstate reality.

S.& P. and First Call both use operating earnings, which are reported earnings adjusted to

remove what are generally known as one-time charges. But S.& P. has a narrower definition of the figure.

For example, the cost of layoffs for the continuing operation of a company does not qualify as a one-time charge at S.& P. The analysts who supply data to First Call have their own definitions, which include layoff costs and other items. Some analysts use pro forma earnings instead of operating earnings, which let a company exclude just about any cost.

This means that the total quarterly earnings for the 500 companies tabulated by S.& P. are generally lower than the earnings collected by First Call. But in the second quarter of last year, this difference was extreme — the biggest since S.& P. began using operating earnings in 1988. S.& P. calculated that the aggregate quarterly earnings for the 500 companies were $9.02 a share, which was 22 percent lower than First Call's estimate. The lower base in the second quarter of 2001 explains a large part of S.& P.'s 29.7 percent second-quarter earnings growth.

In addition, S.& P. does not adjust a previous quarter's earnings to reflect changes in the companies in its index; First Call does. First Call has also revised the second quarter of 2001 to reflect a major accounting change concerning good will, or the difference between what a company pays to buy a rival and what the assets are actually worth. These revisions restored large portions of good-will write-offs, another reason First Call earnings in 2001 were higher than those of S.& P.

Howard Silverblatt, editor for quantitative services at S.& P., said that Wall Street analysts agreed to overlook too many one-time costs, thereby raising earnings totals. He said S.& P. would not adjust prior quarters for changes in the S.& P. 500 stock index or accounting rules because "the earnings are what was known at the time."

Chuck Hill, First Call's research director, said analysts who provided First Call's data allowed too many one-time charges, in part because of pressure from the companies they cover. But he contended that S.& P. was too strict. "We are closer to what the earnings power of a company is and that is what you want when you value a stock," he said.

Next quarter, S.& P. is scheduled to adopt a new profit measurement, called core earnings, that deals with other earnings distortions, including the cost of employee stock options. It is an improvement, but will widen the gap between S.& P.'s tally and that of First Call.

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