

Reading Annual Reports Made Enjoyable – Ernest Nounou* October 6, 2004
A useful framework for demystifying a needlessly complex topic

Overview

Many successful investors don't read annual reports of companies whose shares they own because they have neither the time nor inclination. Annual reports may never be mistaken for something from a Best Seller list, but reading them can be very good for your investing health. And the experience can actually be enjoyable (OK, painless) if you have a simple approach.

A company's annual report is management's opportunity to communicate the splendid results achieved in the past twelve months and prospects for the next twelve months; or fess-up time for poor results and management's plans to turn things around in the next twelve. Most reports fall somewhere in between. It is only natural for any company to trumpet success first and give the bad news later. Some even try to bury bad news in footnotes and gobbledygook language. Good companies are increasingly using clear language in their reports; let's hope the trend continues.

Here is a simple but not exhaustive set of rules to follow in reading annual reports. They may not convert you into a Wall Street analyst, but will help you obtain far more worthwhile information, knowledge, and insight into your investments. (Viewers are encouraged to email us their own tips.)

Rules for Reading an Annual Report

- An annual report and financials therein represents a snapshot at a given moment. By the time it is mailed, an annual report is more history than news.
- Reading history, look for trends over a reasonable time period of at least 3 years.
- Good management will likely get things right over time and will not turn stupid. Of course the inverse is also true.
- If you can't understand language used to describe normal company performance, it's not you; it's them.
- Successful performance is traditionally measured by level and growth of sales and real profits from operations. Everything else is commentary. Periodically, such as during the dot.com era Wall Street experts stood logic on its head and real profits were penalized, while dot.com losses were favored. In the ensuing bust this thankfully ended.

Note: Historically, $2 + 2 = 4$. Periodically "experts" present cases where $2 + 2 = \text{greater than } 4$, but it can never last, and try not to be persuaded.

Suggested Order for Reading an Annual Report

Annual reports are not required to be written in any particular order. Positioning of information is a great barometer of the past 12 months' performance. Any annual report, other than for a .Com, that doesn't begin by discussing sales and profit growth should have the onus of proving why performance was good.

A logical sequence for reading the various sections provides the beginnings of a framework for understanding, digesting and retaining the information, as well as for performing comparative

analysis. This is especially helpful when an investor is considering investing in one of two or more companies in the same industry. So the flipping back and forth from section to section will be worth the effort.

1. CEO Message
2. Auditors' Report
3. Management discussion and Analysis
4. Multi Year Summary of Selected Financial Data
5. Income Statement
6. Balance Sheet
7. Cash Flow Statement
8. Notes to Financial Statements

CEO Message

This section is the company's best shot at providing good news about sales and profits. Bad news, if stated openly and includes plausible explanations for turning things around, is acceptable.

Compare what the CEO delivered against what was promised during the previous year or two. If the trend is consistently over-promising or under-performing, this is akin to an incumbent who promises to get things done during his **next** term.

Auditors' Report

This is the imprimatur of an accounting firm verifying that the financial statements were prepared according to pre-established rules. The best report is a clean unqualified opinion. If there are any qualifications or exceptions, the accounting firm either was not asked or is in no position to confirm certain financial facts provided by management or other accountants. Be guided accordingly depending on the materiality of the information being referenced.

Changing of accounting firms is usually a red-flag item. Accounting firms may be dismissed for reasons tied to performance or lack thereof. More typically, they are dismissed because they will not go along with certain management financial procedures or controls; and are replaced by a firm who will.

Management Discussion and Analysis

Similar but with much more detail than the CEO Message, this section highlights various aspects of the company's activities. A typical report might include discussion and analysis on such topics as:

- Change in accounting practices
- Acquisitions
- Market risks and competition
- Asset impairment
- Business segment performance

This section also tends to be written in more cautionary style than the CEO Message and should be read in conjunction with it.

Multi Year Summary of Selected Financial Data

This section's greatest value is providing a quick opportunity to review financial trends. Besides providing a quick overview of the current year's financial performance, this section typically provides five years of comparable data for:

- Sales – trend should be going up
- Income from Continuing Operations – the trend should be compared with trend for net income. The difference between them might include gain or loss on sale of assets and other non-recurring items.
- Income Per Share from Continuing Operations – this trend should approximate the Income from Continuing Operations trend. If the growth is faster, it could be the result of the company's share buyback - usually a good thing. If the trend is lower, it may result from the company's issuance of additional shares - not a good thing because the value of each share in the company is diluted.
- Long-term Debt – debt is fine if it is growing proportionately with sales and income growth trends. If it is growing at a faster rate, that's not generally a good sign as the company may become overly leveraged.
- Ratios – return on assets, return on equity, and working capital are likely to be found in this section.

Checking a company's financial trend over several years provides a meaningful picture of where the company has been. It also puts into some perspective the CEO's Message and Management's Discussion and comments as to the future direction of the company.

Income Statement

Often referred to as the P & L, this is the most important financial statement, as it gives a yardstick for how well the company performed its business. If it is not the first financial statement presented in the annual report, that should be a red flag, as either sales, income, or both may not have been so terrific. Check out some of the following – it may not be wildly fun but can be interesting to the interested investor:

- Did costs and expenses grow faster than sales growth, and if so, why?
- Were there any significant gain or loss on the sale of assets that impacted profits?
- Did increased profits result from lower taxes?

Sales and profits are good, more sales and greater profits are even better, notwithstanding previous Dot Com-inspired thinking.

Balance Sheet

This snapshot of the company's financial position at any point in time but usually on December 31 shows what a company owns (assets), what it owes (liabilities) and what's left for shareholders (shareholders' equity). Check out some of the following:

Assets

- Cash – should increase and always be at a healthy level to meet current obligations. Some companies borrow money for short-term at year-end to prop up cash for the annual report. This is referred to as “window dressing” and not such a good thing to do. But there is worse.
- Inventory – if the level keeps increasing year over year while sales do not, it may mean the inventory will not sell and may have to be written off.
- Intangible Assets (sometimes referred to as “good will”) – this is actually an important category because it represents a value on such intangible assets as patents, trademarks, the value of an acquired company greater than what it was carried on its own books, etc. This is a tricky area. A good exercise is to deduct this number from shareholder equity to see what tangible assets shareholders own.

Liabilities

- Short-term borrowings – usually bank debt or commercial paper having a maturity of less than one year. Some companies include the current portion of long-term debt in this category.
- Long-term Debt – ideally it should only be growing commensurate with sales, earnings, or for a major acquisition. If it is growing faster, that’s a red flag. Knowing analysts measure long-term debt levels and trends, some companies pay down long-term debt with short-term borrowings. So both measures of debt should be checked.
- Shareholders’ Equity – what shareholders own. Generally, if long-term debt is greater than shareholders’ equity, that is a red flag item and may be an indication of over-leveraging, unless the company is a financial institution or utility, in which case higher leverage is the norm.

Cash Flow Statement

This is actually a useful statement and indicates in understandable terms a company’s sources and uses of funds. These activities net out to an increase or decrease to the company’s cash position from the previous year.

Notes to Financial Statements

This is fine print designed to drive people nuts. Notes can be a source of illumination or where messy stuff is buried. Persevere if you can!

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