

Stock Investing ABCs: How to Read an Annual Report

By John E. Deysher

A portfolio manager I know claims curling up with a good annual report is almost as exciting as getting lost in the latest Dan Brown novel.

But many individual investors are in the other camp, dreading the arrival of all those annual reports that can easily crowd your mailbox.

“Who needs it?” you may ask.

Well, YOU DO—if you’re thinking of investing your hard-earned money in the equity or debt of a particular company.

Annual reports are like chapters in a company’s life, and the good reports give a fairly detailed account of the year just past as well as the outlook for the future. Even if you’re not a financial expert, they’re well worth reading, especially if you have an ownership position.

While the financial statements within an annual report are important, the non-financial information is just as critical. Your goal is to assess how the company is doing in terms of profitability, growth, any existing or potential problems, risks, adequacy of financial resources and other factors. While the numbers tell part of the story, you can tell a lot about a company’s future prospects just by reading the text, which explains the nuances and circumstances surrounding the numbers.

At a minimum, read the chairman’s letter, which may often trigger questions that are addressed later in the report.

Treat the annual report as an annual “report card” on the company’s progress.



First Impressions

One of the first things I notice when opening an annual report is whether the firm spent a lot of money producing it. Lots of glossy pages filled with photos, meaningless graphics or empty space (instead of text) is a red flag. An annual report is not a marketing piece or promotion document. It’s a candid assessment of how well—or poorly—a

firm performed.

Too many pictures of the CEO is also a red flag. This flags a CEO with an ego that can easily rankle the rank and file—who are the backbone of the entire company.

Conversely, if the annual report is all text, financial statements and notes (ala Berkshire Hathaway), and uses every square inch of space efficiently—including the inside of the front and back covers—that’s a good sign.

Also, the company’s address and phone number should be on display should you wish to contact them.

Letter to Shareholders

Let’s start with the “Letter from the Chairman” usually addressed “To our shareholders.”

The letter should be candid, honest and combine an explanation of historical results with the outlook for the future.

At a minimum, it should state what sales and earnings were, how they compared to last year, and provide an explanation of any changes.

How to Get One

If you own stock in a company, you'll normally receive the annual report (and proxy) in the mail a few months after the firm's year end.

If you don't have ownership, you can generally obtain a copy in one of several ways:

- Call or write the company's investor relations department and ask them to mail you one.
- Visit the company's Web site and download it.
- Visit www.sec.gov, perform a company search and download it.
- Call Public Register's Annual Report Service at (800) 426-6825 to request annual reports.

Recently I read an annual report where the chairman stated it was a challenging year but the company made significant progress. The balance of the letter highlighted multiple new sales initiatives, advertising campaigns and acquisition objectives. No mention was made of sales or earnings. And it was pretty clear why: Sales fell for the fourth straight year, and losses were the largest ever. This wasn't disclosed until well into the 10-K, which was attached to the annual report (a practice that is increasingly common).

The shareholder letter should provide insights on the firm's future and its place on the economic or competitive landscape. Without too many details, which might tip off competitors, the chairman should be able to articulate a vision of where the company is going, how it intends to get there and the challenges and opportunities anticipated.

Beware if the language sounds too optimistic or enthusiastic or dwells on how well the stock price did last year: You want a chairman who's running the business and making money for shareholders, not one who's worried about the stock price.

Selected Financial Data

Located close to the chairman's letter there is usually a table showing a summary of the financial highlights for the last five to 10 years. The SEC requires five, but well-run firms usually disclose 10 years of financial data.

The important thing here is to look at the trends:

- Are they getting better or worse?
- Are they better or worse than industry norms?

Sales and Earnings Trends

Make sure to check out the sales and earnings trends. Sales may be increasing while earnings are increasing at a slower rate, signaling margin compression. Conversely, sales may be declining but earnings may be rising, a sign the firm is pruning away low margin or unprofitable business. Ideally, sales and earnings should *both* be rising, with earnings rising faster than sales as the firm leverages its infrastructure.

Sometimes sales and earnings both are rising, but earnings per share are growing at a slower rate. This occurs when the shares outstanding that are used to calculate earnings per share are growing faster than earnings, a phenomenon known as earnings "dilution." Some common reasons for the share base to expand include public stock offerings, exercise of stock options and the issuance of shares to fund an acquisition.

Equity capital is precious and management should strive to keep share issuance to a minimum. While I'm willing to accept some short-term dilution with the issuance of new shares, the ultimate goal is earnings per share "accretion," where earnings rise faster than shares outstanding.

Earnings and Dividends

Normally shown close to the earnings per share line is dividends per share. If dividends per share are rising

faster than earnings per share, the payout rate is increasing. This normally indicates that growth opportunities may be slowing and the firm believes (rightfully so) that excess earnings should be distributed to shareholders. Recent changes in the tax code subjecting qualified dividends to the same tax rate as

long-term capital gains have accelerated this trend.

If earnings per share are growing faster than dividends per share, growth prospects are still good and the firm believes shareholders will be better served by the retention of earnings to fund internal or external (acquisition) growth.

Remember, even though taxes are lower on dividends, they're still taxed twice—once at the corporate level and once at the individual level. Unless you need dividend income, capturing long-term capital gains is always more tax efficient.

Key Balance Sheet Items

Normally, some key balance sheet items are disclosed. The balance sheet provides a snapshot of a firm's financial position at a single point in time.

Total assets are everything a company owns. Those that can be converted to cash within one year are **current assets**.

Liabilities are everything a company owes. **Current liabilities** are those that come due within a year.

Net working capital is the difference between current assets and current liabilities. It's a measure of liquidity and is a key figure to watch from year to year. Bankruptcies can occur when a firm can't meet its current liabilities.

Shareholder's equity is the difference between total assets and total liabilities. It's the dollar value of what the shareholders own—you want it to grow.

Another important figure to watch

Annual Report Crib Sheet: What to Look For

Overall Appearance

Favorable Appearance

Report consists primarily of text, financial statements and notes.

Unfavorable Appearance

Glossy pages, filled with photos, meaningless graphics or empty space. Also too many pictures of the CEO, which indicates a CEO with an ego that can easily rankle the rank and file employees.

Letter to Shareholders

Good Letters

Should be candid and honest, and should provide insights on the firm's future and its place on the economic or competitive landscape. The chairman should articulate a vision of where the company is going, how it intends to get there and the challenges and opportunities anticipated.

Bare Minimum

Should state what sales and earnings were, how they compared to last year, and provide an explanation of any changes.

Trends in Selected Financial Data

Positive Trends

- Sales declining but earnings rising: Indicates the firm is pruning away low margin or unprofitable business.
- Sales and earnings rising but earnings rising faster than sales: This is the ideal, and indicates that the firm is leveraging its infrastructure.
- Earnings per share growing faster than dividends per share: normally indicates growth prospects are still good and the firm believes shareholders will be better served by the retention of earnings to fund internal or external (acquisition) growth.

Negative Trends

- Sales and earnings increasing but earnings are increasing at a slower rate: This indicates profit margins are compressing.
- Earnings rising but earnings per share rising at a slower rate: Signals EPS dilution due to increasing number of shares outstanding (common reasons: IPOs, stock option exercises or issuance of shares to fund an acquisition).
- Dividends per share rising faster than earnings per share: The payout rate is increasing, which is not necessarily a negative for shareholders but it often indicates slowing growth opportunities and that the firm believes shareholders are better served by distributing earnings rather than reinvesting them. Tax law changes have also increased payout ratios.

Key Balance Sheet Items

What to Look For

- **Net working capital:** A measure of liquidity; should be positive year-to-year. Bankruptcies can occur when a firm can't meet its current liabilities.
- **Shareholder's equity:** Should be growing.
- **Net debt:** Rising debt is OK as long as equity is also rising; ideal relationship is for net debt to be no more than 50% of total capital.
- **Return on equity (ROE):** A measure of profitability; the higher the return on equity the better, but beware of a company that generates high return on equity by using debt that is excluded from the denominator.
- **Return on capital:** A better measure of profitability than ROE; the higher the better.

Management Discussion & Analysis

Key Sections to Look At

- Results of Operations
- Liquidity and Capital Resources
- Quantitative and Qualitative Disclosure About Market Risk

Notes to the Financial Statements

Important Issues to Check

- Customer concentrations
- Advertising and research & development spending
- Shareholder's equity
- Outstanding and exercisable options
- Acquisitions and divestitures
- Goodwill & intangible assets
- Business segment details
- Valuation of securities portfolios and inventory accounts

Report of Independent Auditors

Good Report

An "unqualified opinion"

Watch Out For:

- Citation of problems.
- "Going concern" questions, an indication the problems cited have reached the crisis stage.
- A statement that "except for" certain problems or departures from generally accepted accounting principles, the report would present fairly the firm's financial position.

is **net debt**, defined as short-term and long-term debt less cash and marketable securities. Normally, rising debt is not an issue as long as equity is also rising because

the firm is growing. Generally, I prefer net debt to be no more than 50% of total capital (equity and convertibles plus net debt). While a firm may be able to sustain

higher levels when growing, excess debt brings many firms down when sales stop growing (i.e., during a recession).

Sometimes a firm will show various

return calculations that measure profitability. The most common is **return on equity**, which divides net income by average shareholder's equity. Generally, the higher the return on equity the better, but beware of a company that generates high return on equity by using debt that is excluded from the denominator.

A better measure of profitability is **return on capital**, which includes equity, convertible securities and debt in the denominator. This provides a more complete picture of profitability, since it includes all components of capital structure, not just equity.

Management Discussion & Analysis

The management discussion and analysis is the guts of the annual report. It includes several key sections.

Results of Operations

Management will discuss how the company did for the last three years in detail—changes in sales, earnings, margins, tax rates, etc. They will also discuss the impact of significant events, including acquisitions and divestitures, product or distribution channel additions, loss or gain of key customers, and changes in raw material costs. This section should address questions such as: Did earnings go up because of a non-recurring event such as the sale of property or a division?

Liquidity & Capital Resources

Generally, this section addresses capital structure and any changes to it—for example, a stock or debt offering.

If applicable, there may be tables showing projected debt repayments, lease payments and pension obligations.

Risk Disclosure

This section highlights some of the quantitative and qualitative risks shareholders may face as owners of the

business—for example, the vulnerability of raw materials to price increases or the firm's exposure to currency risks or rising interest rates.

Notes to the Financial Statements

The notes contain lots of important facts that may address the following issues you should be aware of:

- Customer concentration: Does any customer account for more than 5% to 10% of sales?
- Advertising and research & development spending: How much, as a percentage of sales, does this firm spend relative to others in the industry? Cuts in the funding of either may spell trouble.
- Shareholder's equity: Is there a dual class share structure? What are the shareholder rights plans?
- Options outstanding & exercisable: What are they as a percentage of outstanding shares?
- Acquisitions and divestitures: What was the nature of the acquisition and what was the price that was paid? What proceeds were received from any divestitures, and was the sale a gain or a loss?
- Goodwill & intangible assets: What is the exposure to a write down if earnings decline?
- Business segment details: How is each business segment doing in terms of sales, operating income, margins and capital requirements?
- How are securities portfolios and inventory accounts valued?

Report of Independent Auditors

Most firms with publicly traded securities will use national or regional audit firms. Many have changed auditors in recent years because of costs or other considerations. This is acceptable, as long as it's not a result of an accounting

dispute, which must be highlighted in an 8-K filing.

In reviewing the audit report, you are seeking an "unqualified opinion" stating that the financial statements were audited in accordance with standards of the Public Accounting Oversight Board (United States) and "present fairly, in all material respects," the financial position of the firm for the last three years.

Watch out for the following:

- Citation of problems such as unresolved lawsuits, debt covenant violations, cash flow problems or loss of market share.
- "Going concern" questions raising doubts about a firm's ability to stay in business. That means that the problems mentioned above have reached the crisis stage.
- A statement that "except for" certain problems or departures from generally accepted accounting principles, the report would present fairly the firm's financial position. This is rare, since most firms strive to resolve such issues rather than disclose them.

In the wake of major accounting irregularities in recent years, auditors are much more diligent in their review of financial statements. They are also much more willing to highlight issues that, in their opinions, readers should be aware of. It's worth reading every paragraph of the auditor's opinion, especially if there are several long paragraphs.

Conclusion

These are some of the basics for measuring a company's health from its annual report. You can learn more about analyzing them from books on security analysis that may be available at your local public or business library.

Over the years, companies have provided more and more information in their annual reports. Profiting from that information is up to you. ▲

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