

Annual report analysis essay



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Events BI > JUNE 2006 What's Important in an Annual Report Running a Faster Paper Chase by Bob Adams Editor's note: This article is based on a class taught by Bob Adams at past CompuFest meetings and is just a sample of the excellent education available at the annual event organized by the Computer Group Advisory Board. This year's meeting will be June 23-25 in Reno, Nev. Bob, a CGAB vice president, will teach sessions titled Advanced SSG Topics: Judgment Aids; Take the Oops Out of the SSG; and Follow Your Stocks: A Monthly Analysis Tool.

CompuFest 2006 details and registration information are available at www.compuFest2006.com. Corporate annual reports are important research tools that enable investors to keep current on the outlook for a company and to follow trends from year to year. Some key trends to watch are sales, profits, inventory, receivables and debt levels.

In addition, read the footnotes to ferret out pertinent information. Annual reports have two major sections: the glossy paper at the beginning and the cheap paper everywhere else. The truly revealing information is on the mundane paper in the back and in the flimsy booklet for the annual meeting notice and proxy statement. Buried a half dozen pages from the back of the proxy statement — sometimes for good reason — is a graph comparing the company's stock price history with that of a peer group and of the S&P 500 index. This graph can't be beat for a snapshot of a company's performance. Stay away from companies with numerous pages of explanatory notes except for industries such as banking that require many notes.

Search for key words such as litigation, relationships, acquisitions and joint ventures. If you find any of these topics, scrutinize them closely. (Editor's note: You probably can run a search for key words in PDFs of annual reports you download from the Internet. Check your Adobe software for this function.

) The relationships area of the annual report discusses loans made to company officers as well as business deals in which officers in both companies are somehow re-lated.

If a search for acquisitions turns up a series of deals, be wary because it's often difficult to grow a company through acquisitions. Improving existing products and creating new, innovative offerings — in other words, “ organic growth” — are usually better ways to grow a company. Information Not To Gloss Over Three areas in the glossy section contain information worth investigating. I discussed them and additional points about analyzing annual reports in an article in the July 2002 issue of BetterInvesting. The Letter to Shareholders or Letter From Management Poor management relies on alibis and excuses when talking about lackluster performance, while good management discusses problems candidly and outlines a plan to reverse negative trends. Management's Discussion and Analysis (MD&A) MD&A covers operating trends and market factors that affect growth and profitability, key concerns of the Stock Selection Guide (the chief stock analysis tool for the BetterInvesting community).

If management indicates a downward trend for the future, review the assumptions in your SSG analysis. The Auditor's Statement Look for any qualifications to the CPA firm's opinion on the company's financials and investigate exceptions or references to the footnotes. Numbers That Really

The crucial numerical data is on the cheap paper in the three main financial statements: balance sheet, income statement and statement of cash flow. Later, I'll show you how to quickly analyze the data with a spreadsheet available at my website. A stock's value comes from a company's long-term ability to create profits from invested capital.

Financial statements are a snapshot of how a company creates value.

Income Statement: Indicates how good the company is at making money — the bottom line. (Ann Cuneaz wrote an article about the income statement in the May issue.)
Cash Flow Statement: Indicates how the company pays for operations and future growth.
Balance Sheet: Indicates what the company owns and owes. A company's financial statements are analogous to your personal finances.

The income statement is comparable to your paycheck stub — a big number at the top and a smaller number at the bottom. The number at the top represents your total pay, and the number at the bottom shows what's left after taxes and expenses: health insurance, retirement, etc. A company's income statement lists the same items, and net earnings represents the “little” number at the bottom. The cash flow statement is similar to your checkbook.

You deposit the value of your paycheck after expenses into your checking account. The company “deposits” net earnings (called operating income), along with other income — income from investing and financing — into its cash flow statement. The statement is similar to your checkbook balance, which represents your cash on hand after expenses. The final report is the

balance sheet. Cash at the end of the year is transferred to the balance sheet, where it becomes part of the assets that you, or a company, own.

That, minus the liabilities, represents your net worth. The same is true of a company, except a company must report its worth at the end of each fiscal year. A company's total assets and total liabilities will always balance — mainly the result of the item called stockholders' equity. Using a Spreadsheet Now let's analyze the financial data in an annual report. My spreadsheet saves time and provides solid analytical information.

Download the free spreadsheet from my website. The website explains what kind of software you'll need and describes resources for free tools you can use instead of costly software. The form looks onerous, but I think I can convince you otherwise. First, let's look at the Intel example that's on my website (above). The company name and ticker on the top of the page and the financial data from the annual report in the right-hand column are all in light green.

You enter that data when you start a new analysis. Look for the legend box near the bottom of the page to learn how the colors correspond to ratings: danger (red) to very good (dark green). The cells on the spreadsheet's left side show the results of the analysis by displaying color-coded numbers, cells and verbiage — all designed to help you complete the analysis. When you allow the cursor to hover over the red triangles in the upper right-hand corner of some of the cells, more information pops up. If you wish to save the report before you start another analysis, click File > Save As and save the form.

You might want to use the company symbol as the file's name — for example, " AnnRptINTC. " Clear the data to start another analysis. Press Ctrl+D anywhere on the spreadsheet to delete the data if you're using Excel. Otherwise, remove the data manually. Now you're ready to enter data in the two light green areas. First, enter the company name and the annual report year at the top of the page.

Next, enter data in the single column of data in the upper right-hand corner of the page. You can get the data from a hard copy of the annual report, but I suggest using the Internet. The Yahoo! link below the light green data column takes you directly to Yahoo! Finance. Type in a ticker symbol and copy the data from the balance sheet into the spreadsheet. The Yahoo! Finance site also has links for the statements of earnings and cash flow.

If you subscribe to the BetterInvesting Standard & Poor's Stock Data Service (formerly Online Premium Services, or OPS), you can import data into the spreadsheet. See the directions and caveats detailed at my website. After you save the data, you're ready to review the spreadsheet analysis.

Remember, the computer, while a marvelous device, is dumb as a stump. Never accept a suggestion derived by the computer without using your intellect to assess the result and apply judgment. There-fore, review the data analysis and let the computer guide you but not dictate to you.

Analyze a company over several years and compare how the company performed recently relative to prior years. By looking at three or four years in succession, a long-term trend will become evident. When you do this, you're really taking advantage of information and data in the annual report. Bob

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Bob is retired from 26 years in radio and television broadcasting, and 13 years as a college professor. Bob Adams is Director and Vice President, Administration, BetterInvesting Computer Group