Appreciating an Annual Report

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THIS IS THE FIRST IN A SHORT SERIES ON HOW to use annual and quarterly reports to help in making good investment decisions. The main aim of the articles is to render these reports familiar to you. Although at first glance they appear to be confusingly different, there is a good amount of standard information contained in each report. In order to get the most out of this series, please obtain a few annual reports via company investor relations offices by phone or Internet, specially-marked stock listings in the *Globe* or *Post* newspapers, or from the Web sites of transfer agents such as montrealtrust.com.

Annual reports—what could be more boring? As accounting documents, they can only be loved by the "supernumerate", people with a head and heart for this kind of numeric detail.

Unfortunately, for the individual investor as well as the professional stock analyst, the annual report is the basic source of information on what a company does, what its future prospects are, and how it has performed in the past. Do you want a quick overview of a company you have heard touted in the press, in a brokerage sheet or on TV? Are you considering another SPP deposit to a stock in your DRIP portfolio? A few minutes of research with an annual and quarterly report can save you a lot of anxiety and money by helping you make an informed decision before investing. Information is power!

A Canadian annual report is normally divided into six sections, presented in the following order. When you have four or five reports at hand, see if they all contain:

- Messages to shareholders,
- Overview of the company,
- Management's discussion and analysis (MDA),
- Financial statements (usually four),
- Notes to financial statements, and
- Corporate and investor information.

• Messages to Shareholders - Often there are separate messages here from the directors of the company and from the managers that the directors have hired to run the firm. They are traditionally upbeat, pointing out how bright the future will be. This kind of positive, optimistic message is often a great source of amusement when things have consistently gone wrong with the company in the recent past! Don't take this section of the annual report too seriously.

• Overview of the Company - How many of us own shares in BCE? Quite a few, I would imagine. How many of us know what BCE does to earn its money? Not so many.

In this section investors can normally learn not only what a company does but what portion of its profits come from which of its products and which geographic regions. And the better annual reports will provide comparative views for the last three to five years in convenient chart form.

Is a company's flagship product becoming less profitable each year? Are its sales in the USA growing or stagnant? Which divisions are a drag on company resources? With a little experience, the answers to these questions can aid an investor to evaluate the stock tips so freely offered by financial pundits.

• Management's Discussion and Analysis - MDA differs from the "Messages to Shareholders" in that it forms part of the legal description of a firm's operations and prospects. If there are errors or misleading statements here, the company could open itself to shareholder lawsuits. Take these comments seriously!

Much of the MDA is taken up with discussion about trends and changes in the financial picture of the company, using the financial statements that follow it as a source. In addition, however, management makes judgements on the information and attempts to predict future occurrences. If the MDA predicts poor earnings for the next few quarters or outlines impending risks from competitors or market forces, these forecasts should not be discounted. The company may overcome these difficulties, but the risk to an investor is high. Maybe one should look elsewhere, either to the competitor or to another sector of the economy.

• Financial Statements - This is the heart of the annual report. While the figures presented here can be "massaged" to such a degree that the adage "the numbers don't lie" is no longer valid. With some basic accounting training and experience reading reports, an investor can learn what to look for. Is that training really necessary? If you want to make serious money, it certainly is. The renowned Peter Lynch, co-author of the outstanding investment book, *Learn to Earn*, recommends—do yourself a favour, take an accounting course!

The first of the four financial statements is the "Balance Sheet". It shows an investor how much a company has in assets and balances this with how much it has in liabilities and in shareholders' value (equity). It is worthwhile checking how much debt a firm is carrying to see if it is overexposed to future interest rate increases or cash shortages. Is its available cash sufficient to meet its near-term obligations? Is it labouring under a crushing long-term debt load relative to what the company is worth? Various books provide "rules of thumb" for different industries to help us put these observations into the proper context and make sound judgements based on the analysis.

An "Income Statement" (known by other names as well) shows what a firm is earning and from what sources. This information is normally presented in columns for each of the last few years so that an investor can discern the trend of earnings growth: positive, negative or stagnant. It also offers clues to the quality of the earnings. If they come from investments or asset sales and not from product sales, watch out! Sooner or later there won't be enough assets left to generate either interest income or income from product sales.

The commonly-used ratios, P/E (Price to Earnings) and EPS (Earnings per Share), are partly based on the income statement. Both ratios allow an investor to compare one company in a similar industry and to discern trends in share price value and profitability. Quarterly reports update these figures.

The "Changes in Financial Position" or "Cash Flow Statement" is useful for more advanced analysis. It reveals the source of a firm's money and how it has been used. Is a company selling off assets, borrowing heavily, generating large deductible amortization and depreciation charges?

"Retained Earnings" or "Shareholders' Equity Statements" are sometimes combined with one or more of the other financial statements. They provide information on how much value (equity) is available to shareholders and whether this figure is increasing or decreasing. Because one share (yours!) in a company represents a unit of claim on this amount, one hopes that shareholder equity will continue to increase at a steady pace.

• Notes to Financial Statements - While the figures presented in financial statements may be entirely truthful, they sometimes in themselves may not tell the entire truth. This is where explanatory notes are useful. They explain special circumstances or provide itemized breakdowns of numbers, allowing an investor to better comprehend what is at stake. The more experience one gains in reading annual reports, the more significant this seemingly arcane information becomes. Companies would not offer this commentary unless it was important.

• Corporate and Investor Information - The final section of an annual report lists the transfer agent for the firm, gives share price information, and provides telephone numbers and Web addresses for the benefit of its owners, the shareholders. If you are a part owner of the business, take advantage of the services offered here.

Conclusion

Appreciating an annual report, like so many other activities, is at first a daunting proposition. It is not made any easier by companies that produce reports that are barely readable or terribly confusing. But with time and a bit of training on our part, they serve as one of the keys to success for those of us who choose to do a portion of our investing on our own.

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