



Appreciating an Annual Report

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LAST MONTH WE LOOKED AT THE BASIC components of an annual report. I hope that you were able to obtain a few reports to see examples of what I discussed. This month we continue to examine basic features of annual reports in order to render them more familiar to us as investors. And remember, just as you don't have to be a famous artist to appreciate fine paintings, you need not be a high-powered accountant or analyst to find value in annual reports.

The financial data in reports is usually analyzed in the form of ratios, of percentages and of trends. Ratios are comparisons of two numbers, normally expressed in relation to 1, eg 2.3 to 1 or 0.65:1. Various ratios can be calculated, depending on whether one is analyzing liquidity, debt, profitability or value. Ratio analysis takes more explaining than a short article can handle, and won't be dealt with here. Information on it can be found in the Canadian Securities Institute's small book entitled "How to Read Financial Statements".

Percentages and trends are a little easier to grasp and calculate, and some companies even make a point of providing this information in their reports. I wish that it was mandatory for all public firms to do so. It would make investing much less risky. The focus of attention in this article is the Income Statement, which provides data allowing an investor to quickly check up on a company's current and past record of profitability.

For our purposes, we will divide the basic Income Statement into three major divisions, corresponding to measures of gross profit, operating profit and net profit.

Gross Profit Margin (GPM)

This first section records the revenues for the firm (the "top line" of the earnings report), less the costs of the materials and labour to make the product (the cost of sales). What's left over is the gross profit, and this figure expressed as a percentage of revenues is the gross profit margin (or GPM, but other names are used for it as well). To illustrate, we use fiscal year 2000 figures for the fictitious ABC Inc.:

Sales revenue	\$100,000
Cost of sales	\$60,000
Gross profit	\$40,000

(The gross profit margin or GPM is $40,000/100,000$ or 40%).

Is this GPM acceptable for ABC's shareholders? That depends on the average figure for all the companies in its sector. If its competitors can charge more for their product so as to increase revenues, or can make the product for less cost, they will be more profitable (have a higher GPM) and may be a better investment choice than ABC. With any luck, you will find the percentage GPM figures already printed in the annual reports you are studying. Otherwise, you'll have to calculate them yourself. Comparative data for competitors and sector averages can be obtained at the library in the *Stock Guide* or from *The Financial Post* or S&P company and industry surveys.

Annual reports are required to provide several years of data to allow investors to follow trends in the company's affairs. In the case of ABC, we could check to see if the GPM is deteriorating year by year, getting better, or stagnating. By listing the percentages side by side it is a simple matter to see in what direction the trend is leading. For those so inclined, the percentage change year-over-year can be calculated by comparing one year's figure to the prior year's, a process termed "horizontal analysis" in contrast to the "vertical analysis" conducted when all figures are expressed as a percentage of sales revenue. What was the percentage increase or decrease in GPM year-over-year for one of the companies for which you have an annual report?

Operating Profit Margin (OPM)

Not all of the costs related to the sale of a product are listed in the first section of the Income Statement. The cost of salespeople and marketing (selling), office staff (administrative) and associated expenses (general expenses, all three together abbreviated as SA & G) are outlined in its second

section. Research and development costs may also appear here, particularly for technology businesses that depend on vital Research and Development (R&D) to survive. For ABC Inc., these costs amount to \$25,000, meaning that its profit is now down to \$15,000. Expressed as a percentage of sales revenue the operating profit margin, or OPM, is 15%.

Once again, an investor can check the annual data provided to discern the trends in ABC's operating profit margin. Are they improving their performance by reducing selling and administrative costs? A comparison of their figures with the average for their industry will be helpful to put ABC's results into context, and not only for profitability measures alone. If ABC has increased its OPM at the expense of R&D expenditures relative to other industry players, they may be thinking short term to make themselves more attractive as a take-over target or simply not managing their long-term prospects well. In either case, you would not want to hold their shares in the longer term when their present product becomes outmoded and they have not developed anything to replace it.

Net Profit Margin (NPM)

The items in this section of the Income Statement do not directly relate to the production and sale of goods, the operating side of the business. They can include interest charges on borrowed or loaned money, capital gains or losses from asset sales, accounting write-downs and other extraordinary, non-recurring gains or losses, and income taxes.

Say that ABC Inc. had \$1,000 in interest charges and paid \$2,000 in taxes. That brings its profit figure down from an operating profit of \$15,000 to a net profit of \$12,000. This is the "bottom line" profit figure for ABC, although it is often also expressed apart from income taxes, other accounting charges, or extraordinary items (sometimes abbreviated as EBITDA or similar terms). In percentage terms, the net profit margin or NPM is 12% as a percentage of sales. Can an investor do better elsewhere?

The same process of trend analysis mentioned above, analyzing this year's figures in relation to previous years' results and those for the industry as a whole, yields a valuable picture of the worth of the firm for investment purposes.

The Bottom Line

Income Statement analysis can provide a helpful starting point for the study of potential purchases for a stock portfolio, or as a check-up on stocks already held. As you become more familiar with annual reports you will be able to use the positive trends that you have discovered in your analysis as a source of comfort when share prices stay stubbornly low. And if you have seen that costs are consistently going down and profitability is going up, you could well

be in on "the ground floor" as far as investing goes and reap a handsome reward for your analytic efforts. Or a deteriorating earnings situation may alert you to sell out long before your broker calls!

Of course, the Income Statement alone does not tell the whole story. The other financial statements have a role to play as well, as does a consideration of the share price of a company relative to others in its sector and to the market as a whole. But this kind of earnings analysis offers us a glimpse of how a company is faring, and it is a company's earnings that determines its share price in the long term.

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