



Appreciating an Annual Report (Part 3)

Robert MacKenzie

IN THIS THIRD AND FINAL ARTICLE I will outline a few hazards in using annual reports to make investment decisions and offer a couple of suggestions to render them more accessible to the small investor. Although annual reports can provide a lot of useful information for investors, there are a number of problems that make our interpretive job more difficult.

For example, annual reports abide by the rules set down by the accounting fraternity designed to ensure a uniformity among reporting companies, termed the Generally Accepted Accounting Principles or GAAP for short. But not all companies must abide by these rules. The banks, for example, being federally and not provincially chartered, can do an end-run around provincial securities requirements by appealing for relief to the federal regulator. One bank did this recently, gaining the right to report its reserve holdings in a different manner than what had been common practice. This unusual method of reporting can lead to an investor mistakenly comparing two banks' net income as if all the items used to arrive at it were reported in the same way for both companies. Why the federal government allowed this, I don't know.

Another difficulty with GAAP rules is that there are substantial differences between American and Canadian practices. Write-offs are accounted for differently in each jurisdiction, for instance. If you are studying a stock that trades heavily in the US, you should turn to the back of the annual report and see what the American investors are being told by their analysts about the company. A firm may well be reporting a good loss in one country and a profit in the other. And this information could have an effect on the stock price and future outlook. If Americans see a loss and sell, while Canadian see a profit and buy, can we say that there is fairness here?

And speaking of write-offs, be careful to note whether the company you are looking at has recently discounted the value of its assets. It is becoming common practice for firms to take a huge accounting loss in one quarter and then start fresh. If you don't check, an annual report could mislead you into thinking all was well. Write-downs clean

up financial statements and make all things new, but the problems that led to the difficulties may not have been solved.

We investors should not only be aware of pitfalls in basic financial analysis, we should be actively writing those in power to get them to make reporting more investor-friendly. If you belong to a shareowners' organization or investment club, encourage them to send letters of protest and appeals for more clarity and fairness. No one else will stand up for you. We should not have to be professional analysts to have timely disclosure made to us by company management or to be able to comprehend a firm's financial results.

The way in which figures are presented in an annual report is one area that can be improved with little difficulty. As was noted in the last instalment of this series, it is helpful to the small investor to have the percentage changes year-over-year already calculated by the company and listed beside the raw numbers. And just as helpful would be vertical analysis, which provides percentages for various items in relation to some overall total. On the income statement, this would mean that individual items are expressed in terms of their percentage of sales revenue. Raw numeric figures are difficult to put into context, especially when there has been a takeover or merger that makes yearly comparisons impossible to grasp at a glance. A relative percentage scale, because it accounts for wide annual fluctuations in dollar amounts, is much simpler and more meaningful.

At this year's annual meeting of Mitel Corporation at the Chateau Laurier Hotel, not only did I enjoy the reports and the fine lunch, I spoke up during the question period. On behalf of small investors I asked that future annual reports present not only raw figures but also horizontal and vertical analysis of them for a period of three to five years. This had been done very well in the past by the former Newbridge Corporation. Much to my delight, the chairman of the board said that he thought that this was a great idea and would take it up with management. We'll see what next year's annual report looks like.

Regulators and companies are unlikely to make investor-friendly changes for ordinary folk unless we tell them

what our concerns are. If you find annual reports confusing, lobby for changes to make them more meaningful. In doing so, you will be helping to maintain fair and transparent markets from which we all benefit.

*Robert MacKenzie, PhD, CFP, CIM, Financial Advisor,
1500 Bank Street, Suite 200, Ottawa, Ontario K1H 7Z2
(613) 726-3310 rkmackenzie@sprint.ca*