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A Little Light Reading

Understanding An Annual Report

Long considered drudgery to read, annual reports do contain some important information if you know what to look for. Here's a look inside them.

by Peter Smolens

They come to our mailboxes like clockwork, although some companies now provide the option for you to download a copy from their website. Some are printed on thin, almost tissue-like paper while others are slick productions with full-color photographs highlighting different sections of the company. If you own stocks or mutual funds, an annual report arrives from companies, financial institutions, and investment companies regularly. Each company's annual report touts that your money is doing just fine and that if you continue to invest with us, your money will continue to grow by leaps and bounds.

Understanding what's in the annual report provides you with knowledge as to how your money is doing in the company or mutual fund. How you read an annual report depends on your purpose. As an investor, your purpose may be to assess the company's profitability, growth, and risks, which may affect your decision if you should continue to invest in that company.

For investors, this is one time during the year that a company provides you with a review of its workings—both the good and the bad. At a minimum, you should review any company or mutual fund's annual report in which you own stock every

year. The audited annual report provides a convenient way to do this. If you own shares in a company, you should receive a copy in the mail or be given an option to read it online.

AUDITED VS. UNAUDITED ANNUAL REPORTS

Publicly traded companies are required by law to issue an annual report upon the completion of an annual audit. By order of the US Securities And Exchange Commission (SEC), the annual report must then be made available to shareholders. Usually, the audit is completed about three to six months after a company closes out its fiscal year. A popular time to close out the year is simply at the end of the calendar year, which is why you see many annual reports released in late spring. However, there are companies that close out their financial calendar at other times throughout the year, not unlike the US federal government, which closes its fiscal year at the end of October.

When you receive your annual report, make sure it's the audited version of the annual report. An audited annual report means that an outside auditor confirming the information has certified that the financial statements are an accurate view of the company, the financial institution, or the investment firm's financial position.

To confirm you have the audited version of the annual report, look for the section titled "Report of independent registered public accounting firm." Some companies put out an additional document—a semi-annual unaudited report. If the annual report does not contain the section just mentioned,

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throw it away and avoid investing in the company, financial institution, or investment firm. That document will be nothing more than a glorified sales tool in an attempt to lure investors. In them, the numbers are always positive and are often what the company *wishes* it will have for the rest of the year. It's only the *audited* results that assure you that there are no mistakes or misstatements in the financial results.

In addition, make sure it's a reputable accounting firm doing the auditing. When you get your annual report, make sure the section titled "Report of independent registered public accounting firm" is signed by one of the so-called "big four" accounting firms—Pricewaterhouse Coopers; KPMG; Ernst & Young; or Deloitte & Touche. Seeing that one of these companies is the auditor can help reassure the reader that proper accounting practices were used in the preparation of the annual report. This report signifies the annual report was compiled using *generally accepted accounting principles* (GAAP), the de facto "bible" of accounting rules. This is necessary to prevent Enron-type investment debacles.

TYPICAL COMPONENTS

There are many different parts of an annual report that can provide insight into the company. I'll describe a few of these sections.

Letter from chairman of the board

Usually on the first page, the chairman of the board or chief executive officer welcomes you to that year's report. The next few paragraphs provide an overview of the past year. Market and industry conditions are used to explain the positive or negative company's stock activity. These conditions explain how corporate goals were achieved or why they were missed. Always highlighted is what the company accomplished or what new products were introduced, making sure to accent what actions were taken when the expected goals were not met. Expect a positive spin on the company's current status.

In the case of investment companies, each fund manager will summarize the past year's successes or failures. The fund managers will explain how they plan to position the mutual fund in the best possible place to maximize profits in the coming years. A careful reading of this letter can show insights into the company's or mutual fund's outlook.

At this point, there are two paths investors often take.

Some will look at the *sales & marketing* section to see what the company sells, as well as how, where, and when. Depending on the type of company, sometimes featured employees will offer insights into their job. Related to this is the *management discussion & analysis* section, which covers what products or divisions have been successful and bring the most money. Here is where a lot of companies place their spin in order to put the previous year in a positive light. This section might also discuss significant financial trends over the past two years and where they think trends are moving. One of your decisions is to determine how accurate those discussions are. You'll see charts and graphs showing a current and projected financial figures summary, often for the next five

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to 10 years. There's good information here, but read it with a dash of skepticism.

Financial statements

Others head directly to the *financial statements* section. Here is where the actual numbers are broken down. All public companies in the United States and Canada must include the following in their annual reports:

- A five-year comparison of selected financial data
- A consolidated balance sheet, an income statement, a cash flow statement
- A statement of changes in stockholders' equity for the past two years.

Usually broken down by division are the sales and profits/loss margins (from the income statement). These figures show whether or not the company makes more than it spends; bottom line, a company without a profit may not be in business very long. The balance sheet shows expenses, which is a static snapshot in time of the company's financial health. These figures include R&D spending, inventory, and debt levels over time. Be sure to note the composition of its current assets (from the balance sheet).

The final area is the actual cash flow versus reported income (from the *cash flow and income* statements). These reports show how the money flows in and out of the company. Negative cash flow means the company is losing money.

In the case of mutual funds, the financial statements show what companies make up the fund. Also shown is how many shares the fund has in each company, which in turn shows the amount of money that is invested in each company. But this also is just a snapshot in time and those investments can and do change. Accordingly, you will typically notice this disclaimer:

Please note: Since publishing the annual report, changes in the information contained in the document are to be expected depending on market conditions.

Read also the footnotes to the financial statements to ferret out additional information. They often describe accounting policies as well as provide more detailed information in such areas as taxes, pension plans, business segment and geographical breakdowns, related party transactions, and future



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financial obligations, critical partnerships, competitive risks and pending lawsuits. These are all critical factors to consider when investing in a company.

Associated with the financials is the *CPA opinion letter*. This letter is written by the CPA firm who conducted the audit as an opinion on the company's financials.

GET IT, READ IT

To get a hard copy of an annual report you can visit a company's website and contact its investor relations (IR) group. Usually, you'll have to leave a message with your name and address; the company will then mail it to you free of charge. To get a copy immediately, most companies allow you to download a copy of the current year's annual report directly from its website.

If it feels like work reading and understanding the annual report issued by either a publicly traded company, a financial institution, or an investment company, you are right. However, as a prudent investor, you need to do your homework and know what is going on with your investments, and this report provides just that information.

Peter Smolens is a writer/photographer/digital artist who recently retired from the working world as a programmer and technical writer. His website is www.pbsstudio1.com.

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