

The Value of an Annual Report

Anual reports are one of the tools available to serious investors that may help them build a better understanding of a company — its current operating results, its financial health, and its likely outlook.

WHY SHOULD INVESTORS BE INTERESTED?

The annual report is one of the most complete and objective sources of information available on every public company. Many annual reports appear, at first glance, to be only glossy pieces of marketing material. In fact, most companies exert considerable effort to produce an attractive annual report and, quite reasonably, try to accentuate the positive by highlighting information that readers will interpret favorably. However, behind all the pretty pictures, there is an abundance of valuable information that provides an investor (or a potential investor) with a better understanding of the company. Annual reports contain a wealth of useful data to aid the investor in determining measures of both value and risk for the company. And while each company attempts to produce its own unique report, the general format of the annual report is largely standardized, which makes it easier to find specific information and to make comparisons with other companies.



WHAT IS INCLUDED?

The U.S. Securities and Exchange Commission (SEC) and Canadian Provincial Securities Commissions (PSCs) both require companies to send shareholders an annual report every year. They also set standards for much of the information that must be included. For example, their regulations define the minimum font size for financial statements and footnotes. Sometimes the full financial review is a separate, but included, document.

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, and a statement of changes in stockholders' equity for the past two years;
- A management discussion and analysis (MD&A) of results and changes over the last two years; and
- Notes to the financial statements that describe accounting policies as well as providing more detailed information in such areas as taxes, pension plans, business segment and geographical breakdowns, related party transactions, and future financial obligations.

WHAT SHOULD INVESTORS LOOK FOR?

Investors can read an annual report on many levels — from just gaining an appreciation of the business to doing more detailed financial analysis. While companies may devote most of the volume of an annual report to pictures and quotations from satisfied customers and/or productive employees, the three financial statements — *Income Statement*, *Cash Flow Statement*, and *Balance Sheet* — are the heart of the report.

At a minimum, serious investors probably will want to review:

- Sales, earnings, and various profit margins (from the Income Statement);
- Debt levels and the composition of current assets (from the Balance Sheet); and
- Actual cash flow versus reported income (from the Cash Flow and Income Statements).

The financial analysis possible from these statements can go on and on. For example, investors can disaggregate

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return on equity (ROE) to determine whether changing profit margins, asset turnover, and/or debt cause favorable (or unfavorable) results.

Investors can scrutinize footnotes to see, for example, which business segments are producing more of the company's sales and earnings than others, what debt the company will need to pay or refinance in the near future, or if the company has significant potential liabilities in its future.

The MD&A is also an enlightening part of the annual report. This section often addresses major changes in sales, costs, tax rates, and the competitive environment. Additionally, it can give insight into the company's operations and future outlook.

The "Letter to Shareholders" section is usually at the beginning of the annual report and it provides the perspectives of the company president, chief executive officer (CEO), and/or the chair of the board. While this section often concentrates on the recent accomplishments of the company, it can also be a thoughtful, informative piece, typically including the company's strategic goals, and the specific plans that the company will implement to achieve them.

Finally, investors need to remember that, although an annual report's financial statements are some of the most consistently objective financial reports available, they are not without shortcomings.



In both the United States and Canada, laws require public companies to prepare these statements in accordance with generally accepted accounting principles (GAAP). However, within GAAP, companies have discretion in

deciding the accounting method to use, such as LIFO (last in, first out) versus FIFO (first in, first out) accounting for inventories. They also have some discretion in the assumptions they use to determine future pension obligations. Companies also have limited independence in deciding whether to expense or capitalize some costs, or when to record sales. All this can impact a company's "quality of earnings" and its comparability with other companies.

The challenge of comparing companies across nations is even more striking, because each country has its own accepted accounting principles and filing requirements.

HOW DO INVESTORS GAIN ACCESS?

There are many different ways to obtain an annual report.

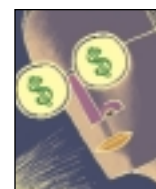
In the United States and Canada, companies must send an annual report to all registered shareholders. However, if an investor owns stock through a mutual fund or investment advisor, the ultimate owner of the stock (the "beneficial" owner) may not automatically receive the report because the "shareholder of record" for the company is the mutual fund or investment advisor. Investors must check with their mutual fund or investment advisor to determine if annual reports are distributed.

Investors usually can request an annual report through a company's investor relations department (many have toll-free phone numbers). Also, many companies' phone numbers are found in investor service publications, such as *Value Line* (www.valueline.com), which is available in most public libraries.

Investors can use the Internet. Many companies include financial reports, press releases, and discussions with analysts on their Web sites.

EDGAR (www.freeedgar.com), the financial database of SEC filings, contains the required annual SEC filing — the 10-K report — for most U.S. companies. Canadian companies submit their required filings to SEDAR (www.sedar.com).

An annual report contains much information that is useful not only for in-depth security analysis, but also for interested individual investors. It is one of the best sources of easily accessible, reasonably understandable data on a company's current operations and its financial health. It contains valuable information that can be used to help predict future results. ■



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