Annual Report Review: Five Pointers

The Spring 2012 issue of *"Graham and Doddsville"*, published by Columbia Business School, includes an intriguing interview with Jim Chanos, during which Chanos states;

"It's amazing how few analysts actually read SEC filings. It blows me away."

This reminds me of a CNN interview with Jim Rogers, entitled *"Best advice I ever got"*. In his early days on Wall Street, Rogers encountered an "old guy" who urged him to always read the annual report of any company he was interested in, claiming that if he did so he would be doing more than 98% of others on Wall Street. Rogers soon realised that most people *"don't bother even doing the basic homework"*.

I am not so sure that the majority don't do the basics but I wholly subscribe to the notion that many do not. These basics should of course always include a thorough review of the relevant filings, the annual report being the most informative of these. Reading analyst reports or blogs is no substitute. Many of our readers will likely have a good grasp of how to review an annual report. For those who do not, I am no sage (I am not even a qualified accountant!). I have however been analysing the published accounts of companies in various industries across the world for many years so I hope I have some informed opinions on what to look out for whilst reviewing annual reports.

Aspiring investors aiming to build their accounting-analysis skill set can find various accounting books and blogs that publish good primers on how to go about interpreting accounts. The aim of this note is not to provide a primer; the aforementioned sources do this better than I can. Rather it is to provide a personal perspective on a handful of matters that I hope will assist at least some readers during their research process.

1. Read but think

Accountants cannot please everyone all of the time. They are essentially charged with creating standard solutions to problems that are sometimes not standard. Two seemingly similar transactions can occasionally confer very different economic meaning yet receive the same accounting treatment. Alternatively, transactions that appear very different, and treated in the accounts as such, can occasionally have similar meaning. The treatment of leases comes to mind here. One company borrows to buy its head office and therefore capitalises a new asset and liability. Another enters into a long-term lease on its facility and yet capitalises nothing on its Balance Sheet. Economically, both may be in a similar predicament but their accounts may appear very different with one seeming to have fewer financial obligations and lower operating

margins than the other. It is surprising how so few commentators on the retail sector, which is of course property-intensive, draw attention to this. Much of the Retail sector across Europe is under extreme pressure, partly the result of the current difficulties in funding leasing liabilities.

It is important to think of the meaning of the numbers as you read. It is not likely that a reasonable understanding of this meaning can be attained without reading all of the notes to the accounts so it goes without saying that an investor must read these.

Anchoring is a bias to be especially aware of as you assimilate the information. I sometimes find avoiding this a particular challenge. Say in reviewing the most recent ten year period you identify that a company's profit margin reached 15% eight years ago, troughed at 8% three years later before rebounding to 14% last year. 8% is not necessarily a "worst case" margin for this company, yet people tend to extrapolate previous peaks and troughs into the future. Such bias got a lot of investors into trouble in the recent recession, not least in the banking sector where past corporate performance proved an utterly useless predictor of subsequent results.

Always read the Report of the Independent Auditors. In 99% of cases there will be an unqualified opinion issued, but read it to be sure there are no points of concern noted.

The Statement of Shareholders Equity is the most overlooked of the financial statements. Always read it. Investors obsess about the P&L but often ignore this statement. Amongst other things, here you can see the effect of asset impairments that may have escaped the P&L, the effect of foreign exchange translation gains/losses on assets and liabilities, the effects of share repurchases or issuance of new share and the effects of adjustments to and the real life experience of the pension scheme.

2. Return on Equity

Over very long periods, stock returns are driven by the growth in profits. Typically, growth in profits overwhelm changes in valuation multiples over decades and in some cases even over vastly shorter periods. As we know, profit growth is determined by the return generated on capital invested. Clearly the most desirable investments are those that can deploy significant sums of incremental capital each year and produce outstanding returns on this additional capital. Companies that produce high returns on equity are often favoured by investors for this reason. However the investor should consider just what exactly the ROE is telling us about the business.

Many high ROE businesses may be unable to sustain these returns if anything more than a small portion of profit is reinvested. In fact this is usually the case for most companies that have become outstanding. This is not necessarily problematic; just don't expect that these companies should produce high rates of growth.

An often useful variation on ROE is Return on Incremental Equity. In particular this can be helpful in considering a future path for returns of very profitable businesses. As indicated, some

companies achieve substantial returns on investments made in prior years, yet may struggle to achieve reasonable returns on new investment. To help gauge this we can attempt to calculate the return on new investment by comparing the change in profits over a period with the change in the level of investment over that same period. For example, if a company earned a Profit of $100 five years ago with $500 equity invested, it achieved a ROE of 20%. If today the same company achieved a profit of $110 with equity invested of $700, its ROE is still an excellent 15.7%, but its return on incremental equity invested over the five year period is just 5% (110-100 / 700-500). This may indicate that management is struggling to find profitable avenues for investment and shareholders are sure to suffer if management continue to deploy new capital at rates of return of just 5%.

Beware the effects of past write-offs of intangible assets. This can cause a substantial reduction in profits in the year of the write-off, which management will try to convince you to ignore as a one-off, but will also have the effect of artificially boosting Returns on Equity for many years into the future. Some businesses report high ROE's merely because vast amounts of capital previously deployed into expensive acquisitions has vanished.

Some other businesses produce low returns on equity because the intangible assets stemming from past acquisitions remain capitalised on the Balance Sheet. Depending on the scale of past acquisitions intangible assets can account for a considerable share of the book value of equity. Sometimes in such instances a more meaningful measure of return is the return on tangible equity is (i.e. profit / equity minus intangible assets). The thinking goes that the investment in intangible assets need only be made once and any growth in profit will drive increased ROE in the future. I believe too many investors jump to this optimistic conclusion. For the following reasons I advise investors to tread cautiously when leaning on return on tangible equity:

- Acquisitions have a low rate of success and are often made at cyclical peaks just before a decline in the profits of the acquired company. Likewise profits of the acquired company may fall as new competition enters or as consumers tire of a faddish product. All of this causes ROE to fall further rather than rise.
- Even if the acquired company's profits are not cyclically or structurally excessive, achieving profit growth is not easy. This may entail developing a new product which may in turn require a new phase of investment in R&D or brand development: just the kind of additional investment in intangible assets management hoped to avoid! Profit growth may also be dependent on marketing products in a new region which will likely require additional investment in developing the brand, a sales force, as well as fixed assets and working capital.
- Some companies are run by empire builders obsessed with making acquisition after acquisition, reinvesting shareholders' capital at low rates of return in the process.

Look at **Thermo Fisher Scientific**, manufacturer of scientific instruments, as an example of a business that seems to have the potential to improve ROE, yet has reported consistently disappointing returns on equity for many years.

Bottom line: many companies offer the promise of raising ROE once acquisitions have been integrated. Sometimes this happens but investors will often be left disappointed when

various 'unforeseen' events conspire against management's plans. Be sure to think just as much about how these plans may fail as you do about how they might succeed.

3. Pension Accounting: The Labyrinth

Reviewing the Pension arrangements of companies is arduous but necessary. Accounting for Defined Benefit (DB) Schemes is complex and many investors struggle to get to grips with the meaning of the numbers published in the accounts. Defined Contribution (DC) schemes (401 K in the US) are an analyst's delight inasmuch as the cost of the plan is clear. When analysing DB schemes we are trying to appraise the discounting to present value of unknown future expenses at a rate that few can agree on and assess management's efforts to smooth the effects of erratic investment returns through the Profit & Loss account.

Hands up, I am no expert on this area but here are a couple of issues to watch out for:

- The net pension liability (Projected Benefit Obligation minus Fair Value of Pension Plan Assets) may seem low but can be subject to great change. For example, if the company allows existing employees to continue to accrue pension benefits and keeps the scheme open to new members, then the "service cost" of the scheme will continue to grow, increasing the liability over time. Also, if the company has used a high interest rate to discount future expenses, this depresses the present value of the liability and guarantees that the liability will grow in the future at a faster rate than would otherwise be the case as the discounting unwinds (the "interest cost").
- Most companies I have seen use overly optimistic forecasts for expected future returns on pension plan assets. This has the effect of artificially boosting net income as companies book expected returns in the income statement. The difference between expected and actual returns as well as other differences between actual experience and expectations usually goes directly through the equity account. For this reason you may see companies with a sizeable pension deficit reporting a net income from pension in the P&L account. Look at the 2006-2008 results of Irish food company, **Greencore Group PLC** for an example of this.

As I see it, key items to consider are: Might the liability be understated and what could cause it to increase significantly in the future? If the Gross liability was to increase by say 50%, to what extent would that impair the value of the company? In which assets is the plan invested and how variable might the returns be? Might the accounting treatments distort the earnings or cash flows of the company via optimistic expectations or pension holidays, for example?

4. Cash Flows

Because cash flows have to be reconciled to the actual change in the cash balance, cash flows are harder to fudge than earnings, which as we know can be inadvertently distorted by erroneous estimates, or worse, manipulated by malign management. As the old maxim goes ;

‘Profit is an opinion, Cash Flow is fact’. I am a wholehearted advocate of assessing cash flows and using these assessments as a key part of valuation exercises. Cash flows fund investment and distributions to shareholders and over the very long term are the life blood of most good investments. That is not to say that all successful investments must produce abundant, steady free cash flows. Many good companies seem to be in a prolonged state of consuming cash for investment: this is ok as long as the returns on investment prove adequate.

I could write for pages about the importance of cash flows and the merits of cash flow based valuation tools, but I won’t because our readers know about all of this. I will however highlight the following items to watch out for when analysing companies’ cash flow statements:

- Cash flows can be overstated when management choose to under invest in the business. A guide as to whether this may be happening is to compare depreciation to capex over time; if capex is considerably lower, ask why this might be. Also comparing the ratio of capex/sales to that of competitor companies might be instructive. Don’t forget to include a deduction for cash spent on intangible assets, such as software, which is a legitimate cost but may be included in a different line of the statement. Also, when other intangible assets such as “customer relationships” or “trademarks” are amortised it is always worthwhile pondering whether the company will actually need to spend to replenish these assets if they should be expected to degrade over time.
- Be aware of changes in working capital trends. Occasionally these can highlight deteriorating fundamentals long before earnings can. If it appears as though the company is building inventory it can’t sell, or significantly extending credit terms to customers to close a sale or extending delays in paying creditors, be mindful as these may indicate deteriorating fundamentals. As an example, Swiss company **Nobel Biocare**, discussed in *“Next Big Things”,* published by the Value Investment Institute in September 2011, experienced a sharp rise in DSO’s (Days Sales Outstanding: a measure of how quickly customers make payment on invoices) from 2005 to 2008, just as business conditions were beginning to deteriorate.
- Watch out for differences between cash taxes paid and cash tax charged in the P&L. Usually these are benign, but if there are consistently large differences, it is worth asking yourself why.
- Some non-cash charges should not be ignored. For example stock based compensation is a non-cash expense but it is an expense nonetheless as insiders are consuming part of shareholders’ return. The technology sector is home to many of the most egregious abuses of shareholders via stock compensation programs. Look at the much-hyped software company **Salesforce.com Inc**, valued at almost $20 billion. For its most recent financial year, it reported free cash flow of $420 million, yet the value attributed to employee stock compensation was $229 million, or more than half of free cash flow. In such an instance, I believe free cash flows likely significantly overstate the value created for shareholders. Personally, I always deduct these expenses from cash flows when I value stocks.

5. Beyond the numbers

The commentary from the CEO and Chairman are among the most interesting sections of the annual report. Here we can get some insight into management's plans for the future and their priorities. For what it is worth, I am always acutely attuned to anything hinting at attitudes to capital allocation (for example the importance placed on return on capital, acquisition aspirations, plans for return of capital to shareholders). Poor capital allocation is the single most significant source of shareholder value destruction. Richer context can be gained by reading five to ten years of previous commentaries to observe any important changes in tone or priorities. An adjacent source of insight into management's philosophy is to listen to investor webcasts and earnings report calls or better still to read the transcripts of these events, if available. It is easier to judge how strongly philosophical convictions are held when management respond to the often frivolous questions posed by Wall Street analysts. If the responses differ from what you had previously heard or expected, beware.

Allied with this is to assess the compensation arrangements of the executives. After all, talk is cheap and peoples' behaviour is invariably aligned with their incentives. Surprisingly here the analysis is typically not straightforward. US companies often report detailed information on compensation arrangements in the separate Proxy filing (titled '14A'). Proxy filings have become, in many cases, impenetrable: it is often genuinely difficult to wade through the material and arrive at a meaningful understanding of just what management are paid to achieve. It seems that boards these days are incapable of determining effective compensation plans that can be succinctly described and once the compensation consultants get their hands on the project the output customarily becomes a monstrosity of complexity: after all the consultants must justify their exorbitant fees. Outside of the US, details are sometimes not adequately disclosed in the Annual Report, if at all. Corporations that reward management for achieving goals genuinely designed to benefit shareholders (measures of Return on capital top the list) are rare and such a feature alone should probably spark investor interest in the company. Most companies reward executives for achieving goals of questionable merit such as "adjusted" eps growth, sales growth, operating margin, or total shareholder return. When the financial incentives clash with management's stated goals, the latter should normally be marginalised in the investor's mind.

To reiterate: the above is not supposed to be a complete checklist. It is intended as a personal reflection on a few matters of interest. We may in the future follow-up with insights on other matters.

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