Analyzing the Annual Report – the easy way
Bob Adams -- bob-adams@comcast.net www.bob-adams.net

Analyzing the Annual Report
the easy way
-- a Structured Approach

"I never read an analyst's report -- unless the Sunday funnies aren't available."
-- Warren Buffett

Company discussed is for educational purposes only -- no recommendation is intended

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2-26-09

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Analyzing the Annual Report
-- a Structured Approach
(Manufacturers/Retailers)

1. **What to read**
2. **What to analyze**

-- for manufacturing/retail companies

*

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Analyzing the Annual Report
-- a Structured Approach
(Manufacturers/Retailers)

- **What Do These Authors Look For?**
  - **Peter Lynch**
  - **Warren Buffett**
  - **Benjamin Graham**

*

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Analyzing the Annual Report

- **Read:**
  - **"To Our Stockholders" letter and/or President/CEO letter**
    - **Are Earnings or Sales down?**
    - **Is the Market down?**
    - **Look for Alibis and Excuses**

Read between the lines*...What's your "gut" feeling?*

*

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Analyzing the Annual Report

- **Look for "fog"** **(circle them in red)**

"Talented people" "Financial Strength"
"Global presence" "Leverage competitive advantage"
"Market knowledge" "Create value for shareholders"

- Read the letter again...
  Underline those things that make sense to you

*

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Analyzing the Annual Report

- **Read the Management's Discussion & Analysis (MD&A section)**

- **SEC Required Discussions in MD&A**
  - **How is business**
    - (Reasons sales are up or down)
  - **Ability to pay debt**
    - (Changes in profitability)
  - **Financial commitments**
    - (Trends on financial resources)

*

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Analyzing the Annual Report

– Read the Auditor's Statement
  - Read enough to recognize "normal" verbiage
  - Look for exceptions -- References to footnotes should be investigated
  - Look for softening of the language used in prior years reports
  - Warning Words:
    – "subject to. . ." "except for. . ."

*

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Analyzing the Annual Report

– Beware of "pro forma"
  - "pro forma" means "perhaps"

– Look at footnotes on the Annual Report
  - If too many -- Stay away (count the pages)
    – Industry sensitive

*

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Analyzing the Annual Report

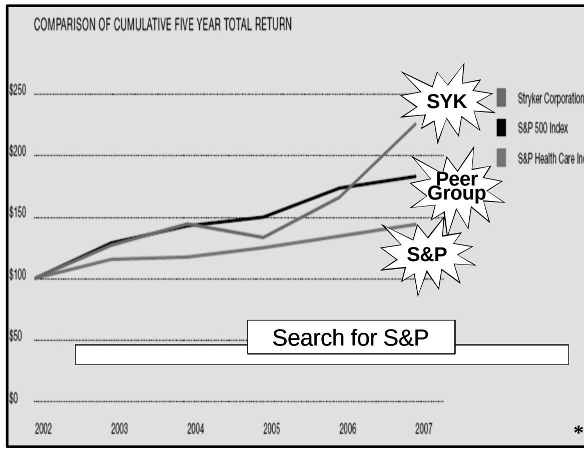
– Use online data (Yahoo – MSN – etc.)

– Annual Report – "Sales Tool"

Observe the "Performance Chart" in the ANNUAL REPORT or 10-K (Section 5)

- Compare the company Total Return with --
  – S&P 500
  – Industry Averages (Peer Group)

*



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Analyzing the Proxy Statement

- Do Directors own shares?
  ✓ Minimum is the value of their salary
- What are qualifications of Audit Committee?
  ✓ Who is on it?
- Look at "Certain" or "Related" Transactions
  ✓ Lists any conflicts of interest
  ✓ Are they buying products from Uncle Joe?

*

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WORLDCOM INC 10-K 2002:
ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

- Commencing in 2000 and continuing through April 2002, Mr. Ebbers requested from time to time that we loan funds to him and/or guarantee loans he had received from other institutions in response to margin calls being made by such institutions following declines in the value of our common stock. In response to his requests, the Compensation and Stock Option Committee of our former Board of Directors approved direct loans to Mr. Ebbers for a total of $165 million.
- The Compensation Committee also approved a guarantee by us of a $150 million loan from Bank of America to Mr. Ebbers and the $45.6 million Bank of America letter of credit noted above. <u>The Compensation Committee approved these loans and guarantees following a determination that it was in the best interest of WorldCom and its shareholders</u> to avoid forced sales by Mr. Ebbers of his common stock.

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Washington Mutual
2007 – 10-K

- **<u>WaMu's $1,325 an hour consultant…</u>**
- In an agreement with retired Chief Legal Officer Fay Chapman, Washington Mutual requires a payment of $2.65 million in consulting fees to Chapman over the next two years. And because the agreement clearly states that Chapman's consulting duties "would not exceed 1,000 hours per year", that works out to $1,325 per hour. If Chapman exceeds those 1,000 hours, "the additional time will be paid on an hourly basis mutually agreed by the parties". <u>And if Chapman dies during the two-year term, Washington Mutual is still on the hook for the full consulting fee</u>.

www.footnoted.org

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Kinder Morgan (KMR) 10-K

- "Our executives are eligible for the same severance policy as our workforce, which caps severance payments to an amount equal to six months of salary. We have no executive company cars or executive car allowances nor do we offer or pay for financial planning services. Additionally, we do not own any corporate aircraft and we do not pay for executives to fly first class."

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Analyzing The Data

- **That's the warm-up –**
  - **getting a "feel" for the <u>company</u>**
  - **getting a "feel" for <u>management</u>**
- **Now, the specifics**
  - **analyze the reported data**

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Analyzing The Data

- **The data originates from three reports**
  - **Income Statement**
  - **Balance Sheet**
  - **Cash Flow Statement**
- **How do they relate to each other?**

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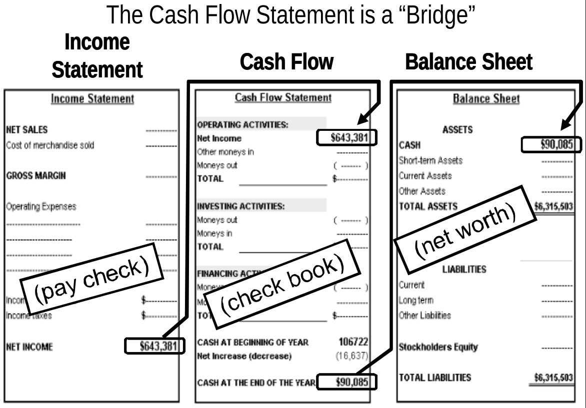
The Cash Flow Statement is a "Bridge"



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The Analysis Tools

1. **Manual form**
   - **Requires a pencil – or can be filled in using the computer**
2. **Spreadsheet manual entry form**
   - **Requires:**
     - ***Excel* (MS Office) or *OpenOffice***
     - **www.openoffice.org**
     - **OR – see my Website**
     - **(Purchase MS Office from Amazon.com—student version**
3. **Spreadsheet automatic data entry**
   - **Requires Excel 2000 or newer**

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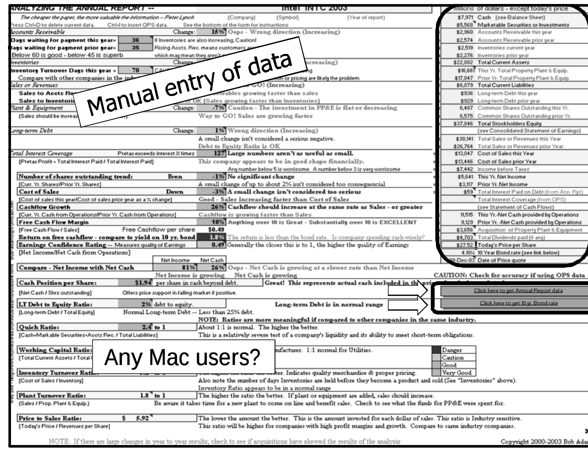
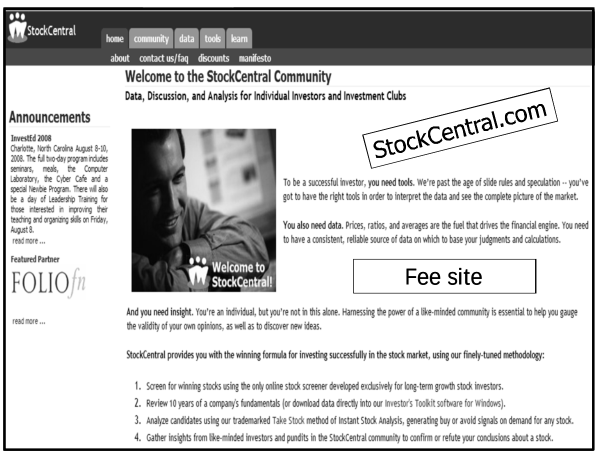
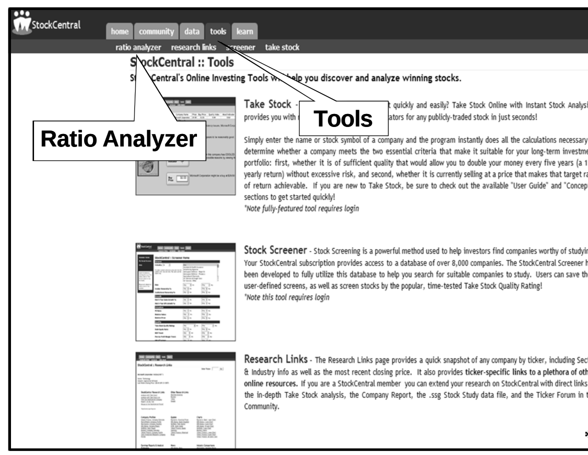
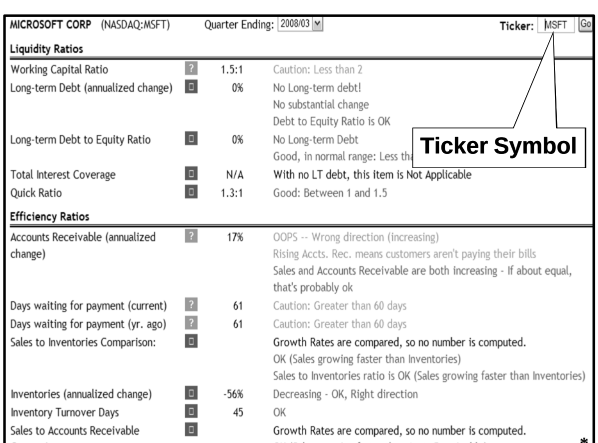
The Data Analysis

- Spreadsheet is available at:
  www.bob-adams.net
  - **Other helps and tools are available as well**
- **(Don't have Internet access? Use your library)**
- **Spreadsheet is to be used as a guide only.**
  No guarantees are intended nor implied.









MICROSOFT CORP (NASDAQ:MSFT)	Quarter Ending: 2008/03	Ticker: MSFT
Liquidity Ratios		
Working Capital Ratio	1.5:1	Caution: Less than 2
Long-term Debt (annualized change)	0%	No Long-term debt! No substantial change Debt to Equity Ratio is OK
Long-term Debt to Equity Ratio	0%	No Long-term Debt Good, in normal range: Less th
Total Interest Coverage	N/A	With no LT debt, this item is Not Applicable
Quick Ratio	1.3:1	Good: Between 1 and 1.5
Efficiency Ratios		
Accounts Receivable (annualized change)	17%	OOPS -- Wrong direction (increasing) Rising Accts. Rec. means customers aren't paying their bills Sales and Accounts Receivable are both increasing - If about equal, that's probably ok
Days waiting for payment (current)	61	Caution: Greater than 60 days
Days waiting for payment (yr. ago)	61	Caution: Greater than 60 days
Sales to Inventories Comparison:		Growth Rates are compared, so no number is computed. OK (Sales growing faster than Inventories) Sales to Inventories ratio is OK (Sales growing faster than Inventories)
Inventories (annualized change)	-56%	Decreasing - OK, Right direction
Inventory Turnover Days	45	OK
Sales to Accounts Receivable Comparison:		Growth Rates are compared, so no number is computed. OK (Sales growing faster than Accts Receivable)

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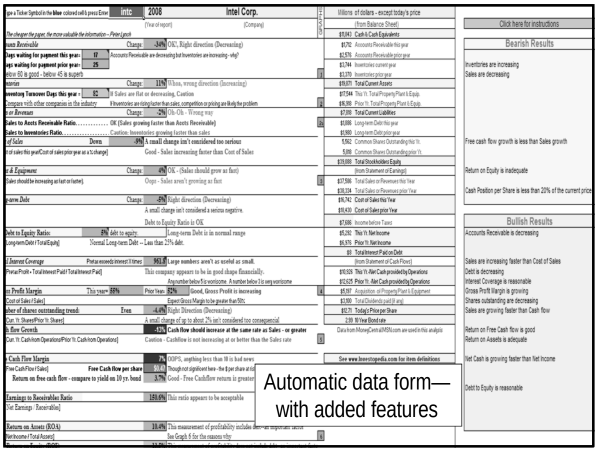
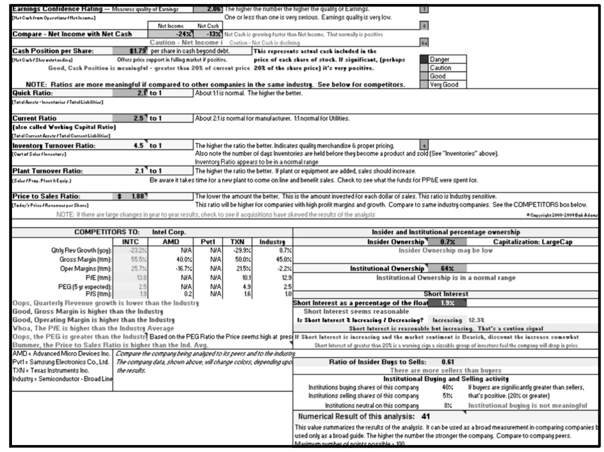
Automatic data fill…

- Newest spreadsheet retrieves data—and graphs key data
  - a live example

Automatic data fill

Refer to the last page of your handout





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Analyzing the Annual Report

- **The Final Step. . .**

The Analysis

We'll look at several years of analysis

*

ANALYZING THE ANNUAL REPORT

version3.12

Type a Ticker Symbol in the **blue** colored cell & press Enter | **intc** | **2008** (Year of report) | **Intel Corp.** (Company)

The cheaper the paper, the more valuable the information -- Peter Lynch

GRAPHS

Accounts Receivable — Change: **-34%** **OK!, Right direction (Decreasing)**

Days waiting for payment this year= 17 — Accounts Receivable are decreasing but Inventories are increasing - why?

Days waiting for payment prior year= 25

Below 60 is good - below 45 is superb — 1

Inventories — Change: **11%** **Whoa, wrong direction (Increasing)**

Inventory Turnover Days this year = 82 — **If Sales are flat or decreasing, Caution**

Compare with other companies in the industry — If Inventories are rising faster than sales, competition or pricing are likely the problem — 2

Sales or Revenues — Change: **-2%** **Oh-Oh - Wrong way**

Sales to Accts Receivable Ratio. . . . . **OK (Sales growing faster than Accts Receivable)** — 2a

Sales to Inventories Ratio. . . . . **Caution: Inventories growing faster than sales**

Cost of Sales — **Down** — **-9%** **A small change isn't considered too serious**

[Cost of sales this year/Cost of sales prior year as a % change] — **Good - Sales increasing faster than Cost of Sales**

Plant & Equipment — Change: **4%** **OK - (Sales should grow as fast)**

(Sales should be increasing as fast or faster). — **Oops - Sales aren't growing as fast** — 3

Long-term Debt — Change: **-5%** **Right direction (Decreasing)**

A small change isn't considered a serious negative.

Debt to Equity Ratio is OK

LT Debt to Equity Ratio: **5%** debt to equity. — **Long-term Debt is in normal range**

[Long-term Debt / Total Equity] — Normal Long-term Debt -- Less than 25% debt.

Total Interest Coverage — Pretax exceeds interest X times **961.8** **Large numbers aren't as useful as small.**

[Pretax Profit + Total Interest Paid / Total Interest Paid] — **This company appears to be in good shape financially.**

Any number below 5 is worrisome. A number below 3 is very worrisome

Gross Profit Margin — This year: **55%** — Prior Year: **52%** — **Good, Gross Profit is increasing** — 4

[Cost of Sales / Sales] — Expect Gross Margin to be greater than 50%

Number of shares outstanding trend: **Even** — **-4.4%** **Right Direction (Decreasing)**

[Curr. Yr. Shares/Prior Yr. Shares] — A small change of up to about 2% isn't considered too consequencial

Cash flow Growth — **-13%** **Cash flow should increase at the same rate as Sales - or greater**

[Curr. Yr. Cash from Operations/Prior Yr. Cash from Operations] — **Caution - Cashflow is not increasing at or better than the Sales rate** — 5

Free Cash Flow Margin — **7%** **OOPS, anything less than 10 is bad news**

[Free Cash Flow / Sales] — **Free Cash flow per share** **$0.47** Though not significant here - the $ per share at risk is reduced by this amount

Return on free cash flow - compare to yield on 10 yr. bond **3.7%** **Good - Free Cashflow return is greater than the bond yield**

Net Earnings to Receivables Ratio — **150.6%** **This ratio appears to be acceptable** — 5a

Net Earnings / Receivables]

Return on Assets (ROA) — **10.4%** This measurement of profitability includes debt--an important factor

[Net Income / Total Assets] — See Graph 6 for the reasons why — 6

Return on Equity (ROE) — **13.5%** This measurement of profitability does not include debt--an important factor

[Net Income / Total Equity] — See chart 6 for the reasons why

Earnings Confidence Rating -- Measures quality of Earnings — **2.06** The higher the number the higher the quality of Earnings. — 7

[Net Cash from Operations / Net Income] — One or less than one is very serious. Earnings quality is very low.

	Net Income	Net Cash		
Compare - Net Income with Net Cash	-24%	-13%	Net Cash is growing faster than Net Income. That normally is positive	8

	Millions of dollars - except today's price
	(from Balance Sheet)
$11,843	Cash & Cash Equivalents
$1,712	Accounts Receivable this year
$2,576	Accounts Receivable prior year
$3,744	Inventories current year
$3,370	Inventories prior year
$19,871	Total Current Assets
$17,544	This Yr. Total Property Plant & Equip.
$16,918	Prior Yr. Total Property Plant & Equip.
$7,818	Total Current Liabilities
$1,886	Long-term Debt this year
$1,980	Long-term Debt prior year
5,562	Common Shares Outstanding this Yr.
5,818	Common Shares Outstanding prior Yr.
$39,088	Total Stockholders Equity
	(from Statement of Earnings)
$37,586	Total Sales or Revenues this Year
$38,334	Total Sales or Revenues prior Year
$16,742	Cost of Sales this Year
$18,430	Cost of Sales prior Year
$7,686	Income before Taxes
$5,292	This Yr. Net Income
$6,976	Prior Yr. Net Income
$8	Total Interest Paid on Debt
	(from Statement of Cash Flows)
$10,926	This Yr.-Net Cash provided by Operations
$12,625	Prior Yr. -Net Cash provided by Operations
$5,197	Acquisition of Property Plant & Equipment
$3,100	Total Dividends paid (if any)
$12.71	Today's Price per Share
2.99	10 Year Bond rate

Data from MoneyCentral.MSN.com are used in this analysis

See www.Investopedia.com for item definitions

Click here for instructions

Bearish Results

Inventories are increasing
Sales are decreasing
Free cash flow growth is less than Sales growth
Return on Equity is inadequate
Cash Position per Share is less than 20% of the current price

Bullish Results

Accounts Receivable is decreasing
Sales are increasing faster than Cost of Sales
Debt is decreasing
Interest Coverage is reasonable
Gross Profit Margin is growing
Shares outstanding are decreasing
Sales are growing faster than Cash flow
Return on Free Cash flow is good
Return on Assets is adequate
Net Cash is growing faster than Net Income
Debt to Equity is reasonable

Cash Position per Share:	**$1.79**	per share in cash beyond debt.	**This represents actual cash included in the price of each share of stock. If significant, (perhaps 20% of the share price) it's very positive.**
[Net Cash / Shrs outstanding]		Offers price support in falling market if positive.	

Good, Cash Position is meaningful - greater than 20% of current price

Danger
Caution
Good
Very Good

NOTE: Ratios are more meaningful if compared to other companies in the same industry. See below for competitors.

Quick Ratio:	**2.1**	**to 1**	About 1:1 is normal. The higher the better.
[Total Assets - Inventories / Total Liabilities]			
Current Ratio **(also called Working Capital Ratio)**	**2.5**	**to 1**	About 2:1 is normal for manufacturer. 1:1 normal for Utilities.
[Total Current Assets / Total Current Liabilities]			
Inventory Turnover Ratio:	**4.5**	**to 1**	The higher the ratio the better. Indicates quality merchandise & proper pricing. 9
[Cost of Sales / Inventory]			Also note the number of days Inventories are held before they become a product and sold (See "Inventories" above). Inventory Ratio appears to be in a normal range
Plant Turnover Ratio:	**2.1**	**to 1**	The higher the ratio the better. If plant or equipment are added, sales should increase.
(Sales / Prop. Plant & Equip.)			Be aware it takes time for a new plant to come on line and benefit sales. Check to see what the funds for PP&E were spent for.
Price to Sales Ratio:	**$ 1.88**		The lower the amount the better. This is the amount invested for each dollar of sales. This ratio is Industry sensitive.
[Today's Price / Revenues per Share]			This ratio will be higher for companies with high profit margins and growth. Compare to same industry companies. See the COMPETITORS box below.

NOTE: If there are large changes in year to year results, check to see if acquisitions have skewed the results of the analysis

COMPETITORS TO: Intel Corp.

	INTC	AMD	Pvt1	TXN	Industry
Qtrly Rev Growth (yoy):	-23.2%	N/A	N/A	-29.9%	8.7%
Gross Margin (ttm):	55.5%	40.0%	N/A	50.0%	45.0%
Oper Margins (ttm):	25.7%	-16.7%	N/A	21.5%	-2.2%
P/E (ttm):	13.8	N/A	N/A	10.1	12.9
PEG (5 yr expected):	2.5	N/A	N/A	4.9	2.5
P/S (ttm):	1.9	0.2	N/A	1.6	1.0

Oops, Quarterly Revenue growth is lower than the Industry
Good, Gross Margin is higher than the Industry
Good, Operating Margin is higher than the Industry
Whoa, The P/E is higher than the Industry Average
Oops, the PEG is greater than the Industry Based on the PEG Ratio the Price seems high at present
Bummer, the Price to Sales Ratio is higher than the Ind. Avg.

AMD = Advanced Micro Devices Inc.
Pvt1 = Samsung Electronics Co., Ltd.
TXN = Texas Instruments Inc.
Industry = Semiconductor - Broad Line

Compare the company being analyzed to its peers and to the industry. The company data, shown above, will change colors, depending upon the results.

Insider and Institutional percentage ownership

Insider Ownership	**0.7%**	**Capitalization: LargeCap**

Insider Ownership may be low

Institutional Ownership	**64%**

Institutional Ownership is in a normal range

Short Interest

Short Interest as a percentage of the float	**1.9%**

Short Interest seems reasonable

Is Short Interest % Increasing / Decreasing? Increasing 12.3%

Short Interest is reasonable but increasing. That's a caution signal

If Short Interest is increasing and the market sentiment is Bearish, discount the increase somewhat

Short Interest of greater than 20% is a warning sign a sizeable group of investors feel the company will drop in price

Ratio of Insider Buys to Sells: 0.61

There are more sellers than buyers

Institutional Buying and Selling activity

Institutions buying shares of this company	40%	If buyers are significantly greater than sellers,
Institutions selling shares of this company	51%	that's positive. (20% or greater)
Institutions neutral on this company	8%	**Institutional buying is not meaningful**

Numerical Result of this analysis: 41

This value summarizes the results of the analysis. It can be used as a broad measurement in comparing companies but used only as a broad guide. The higher the number the stronger the company. Compare to company peers.
Maximum number of points possible = 100