Annual Report

By Michael Kemp

Evolution of the Annual Report

The process of recording business transactions is as ancient as civilization itself. Prior to the Renaissance, methods of accounting were fairly crude, comprising little more than periodic stock-takes and recording cash flows. Owners were usually intimately associated with the operations of their simple businesses hence the need for complex forms of financial accounting had yet to evolve.

Double entry bookkeeping, the accounting method underlying today's financial reports, was first developed in Italy during the 15th Century. But it wasn't until the creation of the first publicly owned companies in 17th Century Europe and the subsequent growth of the corporation as a vehicle for doing business that the need for sophisticated financial reporting came about. The growth of the public corporation saw a widening gulf between ownership and management. This produced an increasing need for the production of reports outlining the business position.

Today the Annual Report is the principal document for conveying information regarding the activities of and the financial state of the business. It is of interest to many groups: shareholders, potential shareholders, creditors, employees, government bodies and social and environmental groups. This article will focus on the information it provides and how it can be best interpreted to achieve good investment outcomes.

Working against transparency

There are two principal forces working against full disclosure in the reports. Firstly, whilst it is intended to provide shareholders with the best possible view on the company's financial affairs, there is equally a reluctance to supply any commercially sensitive information to a company's competitors. Secondly the annual report is often seen as a comment on management's performance. And if that performance has been lacking there could be a temptation to undertake some creative accounting.

Accounting standards

In an effort to provide consistency and sincerity, governments and accounting bodies throughout the world have found it necessary to establish standards governing the production of financial reports. Consistency facilitates inter-company comparisons within a period and intra company comparisons between periods. Sincerity simply means keeping everyone honest. Australian accounting standards are set by the Australian Accounting Standards Board (AASB). These standards define minimum disclosure requirements and how accounting measures are to be undertaken. But the standards introduce an irony; objective methods of measurement can lead us away from economic reality, one of the very reasons they were put forward in the first place. They result in balance sheet distortions due to the use of historical cost, defined rates of depreciation and different treatment of organically grown goodwill vs. acquired goodwill. They also result in earnings distortions again due to defined depreciation rates, but also the use of accrual accounting and "once off" forms of income and expense. For a fuller discussion of these distortions refer to my article *Book Value per Share* in Free Newsletter 120 and at [Buy Books/ Creating Real Wealth]

As a practical example consider how Coca-Cola Amatil was affected by the adoption of Australian International Financial Reporting Standards (AIFRS) several years ago. Despite the obvious commercial benefit of their exclusive distribution licenses Coca-Cola was required to remove their estimated value from its balance sheet. They were deemed an internally generated intangible asset. Overnight both the gearing ratios and return on equity doubled. The former would seem to be bad. The latter would seem to be good. In reality the company was unchanged.

There's an elephant in the room

Both investors and accountants have long known when it comes to financial reporting there is a very large elephant in the room. Double entry book keeping is supposed to provide us with the following equation:

Assets = Liabilities + Equity

The financial stake put up by shareholders is represented by the "equity" component of the formula. Equity can be broken down into two further components: contributed capital and retained profits. Retained profits are recorded as the accumulation of net profit after tax (NPAT) less annual dividends paid. As they accumulate, book value grows (all other things being equal).

But if there are distortions in the earnings and book values shown in the annual report should investors be using these figures for the purpose of selecting share investments? Accountants acknowledge the problem, but their hands are tied by convention and regulation. Investors struggle with the necessary adjustments because the adjustment process requires an intimate knowledge of the business. Simplistic books on the subject of valuation just ignore the problem altogether.

Should the Annual Report be changed?

We are so used to the appearance and format of the annual report that it seems strange to ask whether there is another way this information could be presented. But consider there have been enough books on the subject of security analysis to fill a library. And they almost invariably discuss the need to adjust the information provided in the accounts as the first step in analysis. This includes adjustments to both the income statement and balance sheet figures. So, for the benefit of investors, why aren't the changes made before inclusion in the accounts? There are many reasons, but the principal ones, namely consistency, sincerity and the concept of full disclosure, have already been discussed.

Making the adjustments

In an effort to resolve these issues two economists, Edgar Edwards and Philip Bell, proposed in 1961 that financial reports be presented in a manner that was compatible with present value analysis (a commonly used method of intrinsic value calculation). They suggested an alternative means of measuring balance sheet items and defining profit. Based on their work an American academic, James Ohlson, further developed and later popularized a valuation technique called Residual Income Valuation (RIV). Following Ohlson's description of RIV, in 1995, it has become widely adopted as a valuation tool. RIV demands that the accounting equation (A=L+E) is upheld. This relationship is commonly referred to as the Clean Surplus Relationship. Whilst Edwards and Bell's proposal to change the way accounts are presented was not adopted, analysts acknowledge the principles underlying their proposal and commonly adjust the earnings and book value figures prior to their input to the RIV formula.

A figure which is more representative of annual shareholder's income requires a redefinition of annual expenses - as those expenditures necessary to maintain the economic integrity of the business. In other words, the sum total of expenditures required for the company to maintain its ability to grow and earn at the same rate. If these costs aren't truly represented in the accounts then the investor needs to consider what they are. An obvious example is plant and equipment. An airline which is slow to replace its aging fleet might appear to be making good profits when in reality it isn't. This is because the depreciation expense understates the true cost of maintaining its planes. However, the economic reality of an aging fleet will ultimately bite with the airline either having to sign some big cheques or lose customers. The inevitable fleet upgrade is an expense that should have been recognized by the analyst in earlier years. Under these circumstances the depreciation figure would have been added back to net profit and the appropriate annual cost of maintaining the fleet would have been deducted.

In reconsidering the balance sheet, a fundamental question is whether the figure shown for shareholder's equity (book value) is a true reflection of the cost of reproducing the business. Under or over statement of balance sheet items need to be adjusted in an effort to produce the best possible representation of worth.

Since earnings and balance sheet items are used as inputs in both ratio analysis and valuation formulae, investors always need to consider how representative of economic reality the figures are. For example a commonly used metric is Return on Equity (ROE). It is used both as a measure of managerial capability and as input to intrinsic value formulae. ROE is traditionally calculated by dividing NPAT by book value, with both figures taken directly from the accounts. But given the preceding discussion, the analyst might prefer to use adjusted earnings and adjusted book value instead.

Annual Report as an evolving document

Cash Flow Statement

The Income Statement is based on the concept of accrual accounting whereby revenues and expenses are matched at the time transactions occur, not when payments are made or received. However the Cash Flow Statement recognizes cash flows when they actually occur. It contains three sections; cash flow from investing, financing and operating activities. It is useful in providing a check on the Income Statement since the figures it presents are less subject to manipulation and interpretation.

Sustainability report

The annual report is increasingly including non-financial information. Many companies now include an annual sustainability report which focuses on environmental and social issues. This is occurring for several reasons. Firstly, there is a growing global awareness of the need for companies to behave in a socially and environmentally responsible manner. Secondly, it is in a company's best interests to be seen as responding to these concerns. Thirdly, governments and regulatory bodies around the world are producing guidelines and legislation that actually require companies to respond to these concerns.

Digital delivery

More recently, annual reports have become available via the internet. This has resulted in multiple benefits. Annual reports are now more accessible, cheaper to produce and distribute and impact less on the environment.

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All Michael's previous articles for the website are now on the *Michael Kemp Articles* page on the Free Resources menu. They are now listed by title with a brief description of their contents.

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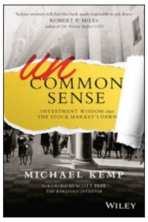

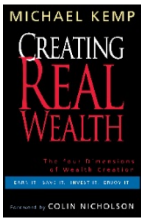

CREATING REAL WEALTH - The four dimensions of wealth creation

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.