SGX
SINGAPORE EXCHANGE

An Investor's Guide To Reading Annual Reports

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An Investor's Guide To Reading Annual Reports

This guide seeks to aid investors in:

- making better use of annual reports;
- focusing on key issues and raising pertinent questions; and
- enhancing their understanding of the overall profile of the companies they are assessing.

In the next few pages, you will find a list of issues and questions that one should bear in mind when reviewing each section of the annual report. No summary list of this length can claim to be exhaustive and we sincerely urge investors to deepen their knowledge through additional readings and courses.

Why should one bother to read the Annual Report?

Because it is usually the **ONLY** published document that provides investors an annual snapshot of the progress of the company, including audited financial statements, operational discussions from management and a briefing from the Chairman.

In many ways, the annual report is much like the report from your annual health check up:

- both require some specialist knowledge to decipher, given industry jargon;
- both provide you a snapshot of part of your well-being: one being physical, the other being financial (if you hold the stock); and
- ignoring salient points lodged in the fine-print can prove disastrous.

Of course, once you have understood the key issues with a company, it would be pertinent to review the interim and full year results that are released by the company more promptly vs. the annual report. These are available online in the Company Announcements section on the SGX website. The list of issues and questions we have provided remain a useful guide in reviewing these releases.

If I only had 10 minutes, what should I look at in the Annual Report?

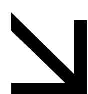
- Glance through the Chairman / CEO's statement. Read the first two and last two paragraphs in detail. This should give you a gist of how the business is going. Do the same for the management discussions and operational analysis.

- Check if independent auditors gave a clean bill of health.

- Look at the financial statements and check if:
  1. net profits are positive, rising or falling;
  2. sales are rising or falling;
  3. operating cash flow after working capital adjustments is positive or negative;
  4. net debt is rising or falling;
  5. dividends are rising or falling (as a % of net profits).

- Look for the segmental breakdown in the notes to the financial accounts and review the sales and earnings for each segment to see if they are improving or declining.

- For all areas which suggest deterioration, look for an explanation in the discussions or seek clarification from the company.



Take Note:

1. An Annual Report is mostly a review of what has already happened.

2. As companies have to be accountable for all public disclosures, forward-looking statements tend to be broad. Investors should ask management for clarification to allay concerns.

3. The primary objective of an audit is to provide a true and fair view of the financial statements. A clean audit report should not be taken as a guarantee that the company is free of fraud.

Some of the questions in the following pages demand more accounting knowledge to properly assess. You will find an asterisk against the question numbers for these.

Section 1 – Introductory pages

- Chairman's statement, business review and outlook, management discussions.
- Seek to understand the company's core business and assess if management is staying focused, addressing risks and remaining consistent in what they say and how they act.

QUESTIONS	RED FLAGS	NOTES
What is the core business? [1] 1. Is there a clearly defined Mission Statement or Strategic business direction? 2. How does the company actually make money? a. Does it sell physical products (e.g. manufacturing) or services (e.g. hospital, school)? b. Can you clearly define the product or service category and customer profile, i.e. geography, demographic? c. What resources (i.e. staff, R&D, investments) must it deploy to satisfy its customers?	If, after reviewing the company profile and introductory pages of the annual report, you remain unclear on how the company makes money, you are best advised to look at another. **Suggestion:** Pick companies in industries you are familiar. **Note:** If the company is a conglomerate (i.e., has multiple unrelated lines of business) concentrate on the key divisions.	
Is management staying focused? 3. What are the management's stated plans to take the business forward? a. Expanding capacity? b. Rationalizing underperforming areas? c. Introducing new products / services to existing customers? d. Investing to raise margins (e.g. new product features, service add-ons) via R&D, marketing, etc? 4. Any acquisitions to facilitate 3a, c, or d?	Question investments or acquisitions in areas which do not facilitate 3a, b, c, or d, e.g. a manufacturing firm buying land for property development. Question if stated plans are unclear, or do not take the company forward, or do not make sense to you in light of what you know.	
Are risks being addressed? 5. What risks have management highlighted? 6. How are these risks being addressed? 7. Has management added to the risks, e.g. more than doubling its size via acquisitions? Can this be effectively managed?	Be vigilant on risks that have been highlighted. Beware of management who fail to mitigate risks. If information on risk mitigation is insufficient, query.	
Is management consistent? [2] 8. Are plans discussed in the past still on-track? 9. Are risks foreseen in the past under control? 10. Is there any change to overall tone? More optimistic or pessimistic?	If past plans are no longer discussed, query. If risks highlighted in the past are no longer addressed, query. If change in tone does not make sense, query.	

Notes: 1. Augment by reviewing the company profile available on the SGX or the company website.
2. Augment by reviewing management discussions given in the last annual report and recent interim results.

Section 2 – Corporate governance disclosure

Review the corporate governance disclosure for consistency with the Code of Corporate Governance 2005 (CG2005) - a 22-page circular that is available on the MAS website.

QUESTIONS	RED FLAGS	NOTES
11. Companies must highlight where they do not comply with the CG2005 guidelines. Review all highlighted areas. 12. Review Independent directors who should be at least one third of board composition. Are they independent?	CG2005 is designed to raise the standards on accountability to shareholders, but true compliance to the spirit of the code relies heavily on the independent directors, so delve into their background to understand them better.	

Section 3 – Financial statements

Review the financial statements to assess various aspects of the business performance and risks from a quantitative perspective. Note that these questions are mostly applicable to companies in the manufacturing, commerce and services sector. The appendix provides questions more appropriate to the specialist sectors of real estate & finance.

QUESTIONS	RED FLAGS	NOTES
13. Did Net profit rise or fall due to change in a. Sales? b. Gross margin? c. Operating margin? d. Interest expense, taxes? * e. Non-recurring items?	We always like to see improvements in sales and margins at all levels. However, the key is to assess sustainability. Red flags would be: - steadily declining margins; - dependency on non-recurring gains.	
* 14. Is cash-cycle rising or falling? Why?	If cash-cycle rises, then inventory and receivables might be piling up too fast. A small red flag.	
* 15. Is operating cash flow sound? a. Is inventory rising much faster than COGS? b. Are receivables rising faster than sales?	Fast growing companies typically register negative Operating Cash Flow (OCFs). Otherwise, negative OCFs are a red flag. Where has the cash been used? Query.	
16. Is Gearing too high? e.g. Net Gearing › 50% * 17. Is Debt repayable within 1 year very close to Net OCF for the firm?	Financial leverage levels are industry specific, and they are best benchmarked against industry peers. Regardless, high short term debt levels vs. cash flow are generally considered risky.	
* 18. Is ROE improving or declining?	Rising earnings with steadily declining ROEs are a red flag.	
* 19. Review changes to accounting policy, e.g. depreciation and R&D capitalization.	Changes to accounting policy can distort earnings. Beware of changes that bring forward revenue or delay expense recognition. Query if reasons are not clear.	

Section 4 – Other issues

QUESTIONS	RED FLAGS	NOTES
Segmental details. (Find these in the notes to financial statements) * 20. Assess the segmental breakdown of sales, profitability, assets & capital expenditure. a. Is YoY change in sales and earnings by geography in synchrony with economic conditions for those regions? b. Do capital expenditure figures make sense vs. answers to Q3 and Q4? c. For banks, note the loans growth by segment. Is the bank taking sensible risk vs. current economic condition? d. For real estate, note capital expenditure by geography. Are they expanding exposure sensibly?	Weakness in some segments might be offset by gains in others. This breakdown can sometimes help identify stability and non-recurring boosts.	
Rewarding shareholders with cash dividends * 21. Is there a stated dividend policy with a specific Dividend Payout? Is Actual Dividend Payout steady, rising or falling? Note that Dividend Payouts can range from 0% (typical of high growth firms) to 100% (very stable cash cows). Companies expecting modest 5-15% annual growth can theoretically afford 20% to 40% dividend payouts.	Question when companies cut dividend payouts. Be wary of companies which accumulate cash on their balance sheet with no clear investment plans.	
Is the cash really there? * 22. Reconcile cash level to interest income. * 23. Are cash holdings excessive vs. stated investment plans?	If interest yield is too low vs. available interest rates for an extended period, be wary.	
Is the company doing what they say? * 24. Which segments are seeing capital employed/ total assets rising? Is this in line with answer to Q3? (Also see Q20) * 25. Which asset items on the balance sheet are rising or falling? Is this in line with answer to Q3?	If the items on the balance sheet (asset item) or in the segmental breakdown do not reconcile with the answer to Q3, be wary.	
Audit result? 26. Did independent auditors give a clean bill of health?	Beware of qualifications and emphasis of matter by auditors.	

Appendix

Real estate companies

QUESTIONS	RED FLAGS
Gearing vs. Economic Cycle 1. Is gearing level appropriate given economic outlook?	High gearing levels are a red flag when headed into an economic decline, but might actually be welcomed in a recovering or growing economy. Still, operating cash flow should be sufficient to repay short term debt.
Trend in income statement 2. Are sales rising YoY? 3. Are earnings rising YoY? 4. Is gross margin improving YoY?	Steadily rising sales and earnings are a positive sign, but given the cyclical nature of this industry, the outlook is far more important. See Q20. Gross margins are a combination of inventory inflation and developer margins – investors should query which projects might have caused significant period-to-period variations.
Quality of property portfolio (detailed disclosure is mandatory) Are you optimistic on the major projects that remain in the portfolio? Have they continued to sell vs. last year?	Assessing the value of this portfolio (be it raw land or work-in progress) is very important, second only to judging the economic cycle.

Banks & Finance companies

Analysis of financial institutions is a specialist field, hence only a basic framework is provided here for better understanding of the more salient aspects in their annual reports.

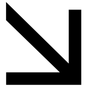
QUESTIONS	RED FLAGS
Asset Growth 1. How fast are loans growing vs. industry? (Industry statistics are usually available from monetary authorities.) 2. Is loan growth too aggressive given economic cycle?	Above average loan growth is a good sign except when heading into an economic peak.
Profitability 3. Is net interest income rising? 4. Is non-interest income rising? Is this mostly from steady or non-recurring sources? 5. Are operating expenses under control? Calculate YoY change in ratio of total expense/total income? 6. Are loan loss provisions rising? Sufficient?	Generally, growth from steady earnings sources like net interest income, fees, are considered better quality than those from trading. Loan loss provisions are the swing factor in earnings during economic busts – i.e. they can become dangerously high if loan growth was too aggressive into economic peaks (see Section 4).
Equity sufficiency 7. Is Tier 1 CAR (Capital Adequacy Ratio) above mandatory minimum? (Currently 6% in Singapore, 2009) 8. Is Total CAR above mandatory minimum? (Currently 10% in Singapore, 2009)	Countries usually stipulate their own minimum CAR levels. Singapore banks have tended to be conservative, staying over 2% above minimums. CAR sufficiency is no guarantee against bankruptcy risk.

Glossary of common Acronyms and Terms

TERM	EXPLANATION
AR	Annual Report
CAR or Capital Adequacy Ratio	Sophisticated measure used to assess the sufficiency of equity to cover the balance sheet risks of financial institutions. The monetary authorities in all countries generally require this to be disclosed and it is thus best for the amateur investor to use what is given than attempt to replicate calculations. In general, this is the ratio of risk-weighted assets to the adjusted equity of the financial institution.
Cash cycle	Shorter cash cycles mean companies are able to convert the profit from sales into cash in a shorter time, hence requiring less investment from shareholders to keep the business going and growing. The common computation for this is: (Trade receivables + Inventory – Trade payables)/Sales x Duration of Sales. Thus, if you use quarterly sales, Duration would be 90 days, and 365 days for annual sales. Example: 1. From the Balance sheet, under Current assets - Receivables from trade: $100,000 (FY2005); $120,000 (FY2006) - Inventory: $50,000 (FY2005); $80,000 (FY2006) 2. From the Balance sheet, under Current liabilities - Payables from trade: $80,000 (FY2005); $110,000 (FY2006) 3. From the Income statement (or Profit & Loss statement): - Annual sales: $520,000 (FY2005); $800,000 (FY2006) - 4th quarter sales: $150,000 (4Q2005); $225,000 (4Q2006) Calculations: • Cash cycle for FY2005 - (Trade receivables + Inventory – Trade payables)/Sales x Duration of Sales [with FY2005 data] - ($100,000 + $50,000 - $80,000)/$520,000 x 365 days [Duration of sales is 365 days for full year] - 49.1 days • Cash cycle for FY2006 - ($120,000 + $80,000 - $110,000)/$800,000 x 365 days - 41.1 days • Cash cycle for 4QFY2005 - ($100,000 + $50,000 - $80,000)/$150,000 x 90 days [We use 90 days for quarterly sales duration] - 42.0 days • Cash cycle for 4QFY2006 - ($120,000 + $80,000 - $110,000)/$225,000 x 90 days - 36.0 days In this example, the company is seeing improvement in the cash cycle since the time taken to convert each dollar of cash is getting faster, from 49.1 days in FY2005 to 41.1 days in FY2006, and from 42days in 4Q2005 to 36 days in 4Q2006.
CG = Corporate Governance	A term that has become increasingly important as it describes the overall management (governance) of a company with respect to all its stakeholders. While commonly considered as the responsibility of top management and the board of directors to shareholders, a more comprehensive view would also consider the responsibility of shareholders (e.g. in attending shareholder meetings and raising concerns, voting their views) and responsibilities to the broader society (e.g. environmental considerations).
COGS = Cost of Goods Sold	This item is usually identified clearly in the income statement. It is the sum of all costs directly associated with sales. These typically include commissions, materials costs and direct wages.
Dividend Payout Ratio	The most common definition is (total dividends for the year)/ (net profit).
Equity	Essentially the amount of money that has been put into the business by the owners of the business, including all accumulated earnings and reserves. Also commonly known as Shareholders funds, which will include paid up capital, all forms of reserves and (usually) minorities' interest.

Gearing / Net Gearing	A term used to compare overall debt to equity. Common computations are: Total Debt / Total Equity or (Total Debt – Cash & Cash-equivalents)/Total Equity. The latter is sometimes more specifically referred to as Net Gearing. Example: Assume balance sheet shows • Long term debt of S$200,000 ; • Short term debt of $100,000, • Cash and Bank deposits of $50,000 • Total shareholders' funds of $500,000, Then Gearing will be Total Debt/Total Equity = ($200,000 + $100,000)/$500,000 = 60% Net Gearing will be (Total Debt – Cash & Cash Equivalents) / Total Equity = ($200,000 + $100,000 - $50,000)/$500,000 = 50%
GM = Gross Margin	The ratio of Gross Profit to Total Sales, where Gross Profit is the profit achieved from sales after deducting Cost of Goods Sold (see explanation of COGS above).
Interest Yield	Ratio of Total interest income to Interest generating assets (e.g. Cash & Cash Equivalents like bonds).
Loan loss provisions	In the income statement, this would be an expense item associated with actual or potential losses on loans. In the balance sheet, this would be the cumulative cushion against potential losses on loans extended.
Net Margin	(Net profit after tax and minorities interest) divided by total sales.
Non-Recurring Expenses	Expenses that are considered one-off in nature. These include losses due to divestment of long term investments at below net book value, retrenchment costs, foreign exchange translation losses (unless there are grounds to believe this will continue).
Non-Recurring Income	Income sources that are one-off in nature, e.g. gains from divestment of long term investments, foreign exchange translation gains, adjustments due to acquisition of assets below fair value.
OCF (& Net OCF)	Operating Cash flow. This should be clearly identified in the Cash flow Statement in the Financial Statements section of the annual report. It is the cash generated from all operating activities, after adjusting for the need to fund increases in working capital. Net OCF is simply OCF after subtracting interest expenses and taxes actually paid.
Op Margin or Operating Margin	The ratio of Operating Profit to Total Sales, where Operating Profit is the profit achieved from sales after deducting all costs related to the running of the business. For analytical purposes, we will generally exclude non-recurring income and expenses, interest income and expense, taxes.
ROE = Return on Equity	This is the ratio of (Net Profits after tax and minorities)/(Equity excluding minorities' interest). This is the most commonly used ratio to assess the efficiency of capital in generating earnings. Generally, ROEs can range from sub-10% (commodity type business) to over 20% (usually strong value creators).
Working Capital	Commonly calculated as Inventory + Trade receivables – Trade payables. Generically, one should consider all items that are required to fund the operations. Therefore, a broader definition would be (Current Assets excluding Cash & Cash Equivalents) - (Current Liabilities excluding Debt & Debt Equivalents). Example: Assume balance sheet shows • Current assets of $500,000 • Within Current assets, you have cash and bank deposits of $100,000 and short term investments of $50,000 • Current liabilities of $350,000 • Within Current liabilities, you have debt (or bank borrowings, leases) of $80,000 Then your working capital would be • (Current Assets minus Cash & Cash Equivalents) - (Current Liabilities minus Debt & Debt Equivalents) = ($500,000 - $100,000 - $50,000) – ($350,000 - $80,000) = $80,000
YoY	Year on Year. The increase or decrease from one year to the next year, e.g. 2006 YoY would be the increase or decrease from 2005 to 2006.

Source: Universe Within Pte Ltd (used with permission)

 **Notes:**

Singapore Exchange Limited
2 Shenton Way #19-00 SGX Centre 1
Singapore 068804
Tel: (65) 6236 8888
Fax: (65) 6533 4310
Website: www.sgx.com

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