

Annual Report Analysis

Introduction:

This is the 4th and final lesson in a series about reading financial statements. We know that NAIC's Stock Selection Guide (and other forms) provide us with much of the information we need to successfully invest in stocks. But it's also important to have a basic understanding of where the numbers come from.

We have already reviewed the Income Statement, Balance Sheet and Cash Flow Statement—the 3 main financial statements that every company is required to provide to its shareholders. Now we must put that information to good use.

Finding an Easy Format for Assessing Annual Reports:

It is imperative that each stock watcher do their due diligence every year by reading and reporting on their company's performance, as laid out in their annual report. Not only will the club want to know the growth rates we've enjoyed, and the future prospects of the company, we will also want to know if the numbers reveal any problems coming down the pike.

In the past, there have been many forms and checklists created to deal with the boring ratios that plague this task. More recently, however, two NAIC aficionados have developed computerized forms to help make this process more enjoyable.

One is called **Making Short Work of an Annual Report by Paul Schneider**. This form must be filled out by hand, but he gives an excellent review of each ratio and what lies behind the numbers. This form can be found on Lowell Herr's website at: www.bivio.com/bullrun/files/AnnualReports

The other option is **Analyzing the Annual Report – A Structured Approach by Bob Adams**. This form has been around for quite awhile and is used by many NAIC members. Bob has a nice "manual" form that must be filled out by hand. But more recently, he has created one that can be filled out on computer. The results are color-coded to warn of pending problems. We can even download OPS datafiles into the spreadsheet to make the task even quicker! And, he has added a separate spreadsheet for banks and financial institutions. The spreadsheets are available in MS Works and MS Excel formats. These, and the manual form, can be downloaded at Bob's website at: www.bobadams.homestead.com/bobsite.html

For this lesson, we will be using Bob Adams' Excel spreadsheet for regular companies, and Mentor Corporation's financial statements, which were printed from their 2002 annual report, available online at their website. We will pass out copies of the financial statements and, together, we will fill in the appropriate information. After that, we will hand out the completed form and go over the results.

Proposal for Reviewing Annual Reports:

While not every ratio will be important to our club, we need to make sure we have some type of assurance that our stock watchers are doing their job reviewing the annual report. Therefore, after the lesson, there will be a proposal made to incorporate this one-page spreadsheet into our required annual reporting for each company. The completed forms can be placed in our stock watcher notebooks.

CONSOLIDATED BALANCE SHEETS

YEARS ENDED MARCH 31, (IN THOUSANDS)	2002	2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 60,398	\$ 63,854
Marketable securities	14,106	584
Accounts receivable, net of allowance for doubtful accounts of \$3,870 in 2002 and \$3,578 in 2001	64,786	57,427
Inventories	47,404	46,721
Deferred income taxes	11,950	10,116
Prepaid expenses and other	12,488	9,331
Total current assets	211,132	188,033
Property and equipment, net	54,656	51,149
Intangible assets, net	37,588	37,773
Goodwill, net	9,155	6,547
Long-term marketable securities and investments	11,752	5,704
Other assets	353	1,631
	\$ 324,636	\$ 290,837
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Account payable and accrued liabilities	\$ 70,423	\$ 55,246
Income taxes payable	3,979	2,992
Dividends payable	704	710
Short-term bank borrowings	9,470	16,624
Total current liabilities	84,576	75,572
Deferred income taxes	3,009	8,268
Long-term accrued liabilities	12,873	10,691
Commitments and contingencies		
Shareholders' equity:		
Common Stock, \$.10 par value:		
Authorized - 50,000,000 shares; Issued and outstanding - 23,472,952 shares in 2002;		
23,671,770 shares in 2001;	2,347	2,367
Capital in excess of par value	-	7,625
Accumulated other comprehensive income (loss)	(6,487)	(4,282)
Retained earnings	228,318	190,596
	224,178	196,306
	\$ 324,636	\$ 290,837

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF INCOME

YEAR ENDED MARCH 31, (IN THOUSANDS, EXCEPT PER SHARE DATA)	2002	2001	2000
Net sales	\$ 321,062	\$ 268,894	\$ 249,345
Costs and expenses:			
Cost of sales	130,455	104,696	94,658
Selling, general, and administrative	111,285	100,379	98,555
Research and development	21,806	19,632	16,701
Restructuring charge	-	2,400	-
	263,546	227,107	209,914
Operating income	57,516	41,787	39,431
Interest expense	(859)	(276)	(34)
Interest income	2,217	4,209	2,982
Other income, net	342	829	10
Income from continuing operations before income taxes	59,216	46,549	42,389
Income taxes	17,396	14,731	13,563
Income from continuing operations	41,820	31,818	28,826
Income from discontinued operations, net of income taxes	-	260	7,713
Net income	\$ 41,820	\$ 32,078	\$ 36,539
Basic earnings per share:			
Continuing operations	\$ 1.77	\$ 1.35	\$ 1.18
Discontinued operations	-	0.01	0.32
Basic earnings per share	\$ 1.77	\$ 1.36	\$ 1.50
Diluted earnings per share:			
Continuing operations	\$ 1.71	\$ 1.32	\$ 1.16
Discontinued operations	-	0.01	0.30
Diluted earnings per share	\$ 1.71	\$ 1.33	\$ 1.46

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEAR ENDED MARCH 31, (IN THOUSANDS)	2002	2001	2000
CASH FROM OPERATING ACTIVITIES:			
Income from continuing operations	\$ 41,820	\$ 31,818	\$ 28,826
Adjustments to derive cash flows from continuing operating activities:			
Depreciation	9,982	8,528	7,760
Amortization	3,866	1,812	973
Deferred income taxes	(4,799)	(1,438)	529
Tax benefit from exercise of stock options	2,975	2,133	2,077
Loss (gain) on sale of assets	456	(64)	401
Imputed interest on long-term liabilities	512	-	-
(Gain) loss on long-term marketable securities and investment write-downs, net	301	(1,142)	(134)
Changes in operating assets and liabilities:			
Accounts receivable	(8,366)	2,144	(7,879)
Inventories and other current assets	(5,338)	(3,063)	(5,645)
Accounts payable and accrued liabilities	16,025	3,173	11,631
Income taxes payable	997	(1,810)	(4,994)
Net cash provided by continuing operating activities	58,431	42,091	33,545
Net cash provided by (used for) discontinued operating activities	-	260	(8,557)
Net cash provided by operating activities	58,431	42,351	24,988
CASH FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(15,094)	(7,457)	(9,195)
Purchases of intangibles	(166)	(2,710)	(2,240)
Purchases of marketable securities	(161,200)	(75,552)	(50,715)
Sales of marketable securities	140,329	129,870	3,757
Acquisitions, net of cash acquired	(4,347)	(32,896)	-
Other, net	(46)	(56)	(1,028)
Net cash (used for) provided by continuing investing activities	(40,524)	11,199	(59,421)
Net cash provided by discontinued investing activities	-	-	59,392
Net cash (used for) provided by investing activities	(40,524)	11,199	(29)
CASH FROM FINANCING ACTIVITIES:			
Repurchase of common stock	(18,715)	(28,069)	(19,402)
Proceeds from exercise of stock options	6,830	2,487	5,665
Dividends paid	(2,839)	(2,380)	(2,442)
Borrowings under line of credit agreements	6,825	19,953	-
Repayments under line of credit agreements	(13,372)	(6,000)	(4,000)
Net cash used for financing activities	(21,271)	(14,009)	(20,179)
Effect of currency exchange rates on cash and cash equivalents	(92)	-	-
Increase (decrease) in cash and cash equivalents	(3,456)	39,541	4,780
Cash and cash equivalents at beginning of year	63,854	24,313	19,533
Cash and cash equivalents at end of year	\$ 60,398	\$ 63,854	\$ 24,313
SUPPLEMENTAL CASH FLOW INFORMATION			
Cash paid during the year for:			
Income taxes	\$ 18,945	\$ 14,009	\$ 8,365
Interest	\$ 645	\$ 152	\$ 51
SUPPLEMENTAL NON-CASH INVESTING AND FINANCING ACTIVITIES			
Issuance of common stock in acquisition of South Bay Medical	\$ -	\$ 4,000	\$ -
Issuance of common stock in acquisition of intangible assets	\$ -	\$ 9,122	\$ -
Liabilities accrued related to the acquisition of intangible assets	\$ 2,685	\$ 10,720	\$ -

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

ANALYZING THE ANNUAL REPORT --

Mentor Corp. (MNTR) 2002

Millions of dollars - except today's price

The cheaper the paper, the more valuable the information -- Peter Lynch
 Press Ctrl+D to delete current data. Ctrl+I to insert OPS data. See the bottom of the form for instructions

Accounts Receivable Change: **13%** **Oops - Wrong direction (Increasing)**

Days waiting for payment this year= **74** If Inventories are also increasing, Caution!

Days waiting for payment prior year= **78** Rising Accts. Rec. means customers aren't paying their bills

Below 60 is good - below 45 is superb which may mean they aren't satisfied with the product.

Inventories Change: **1%** **Whoa, wrong direction (Increasing)**

Inventory Turnover Days this year = **133** CAUTION -- Both Accts. Receivable & Inventories are increasing

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

Sales or Revenues Change: **19%** **Way to GO! (Increasing)**

Sales to Accts Receivable Ratio. OK (Sales growing faster than Accts Receivable)

Sales to Inventories Ratio. This ratio is OK (Sales growing faster than Inventories)

Plant & Equipment Change: **7%** **OK - (Sales should grow as fast)**

(Sales should be increasing as fast or faster). **Way to GO! Sales are growing faster**

Long-term Debt Change: **21%** **Wrong direction (Increasing)**

Why are they taking on more debt? What is the debt to equity ratio?

Debt to Equity Ratio is OK

Total Interest Coverage Pretax exceeds interest X times **#N/A**

[Pretax Profit + Total Interest Paid / Total Interest Paid]

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

Number of shares outstanding trend: Even **-1%** **No significant change**

[Curr. Yr. Shares/Prior Yr. Shares]

A small change of up to about 2% isn't considered too consequential

Cost of Sales Up **25%** **Caution - Why is it increasing?**

[Cost of sales this year/Cost of sales prior year as a % change]

CAUTION - Cost of Sales increasing faster than Sales

Cashflow Growth **39%** Cashflow should increase at the same rate as Sales - or greater

[Curr. Yr. Cash from Operations/Prior Yr. Cash from Operations]

Cashflow is growing faster than Sales

Free Cash Flow Margin **13%** **Anything over 10 is Great - Substantially over 10 is EXCELLENT**

[Free Cash Flow / Sales]

Earnings Confidence Rating -- Measures quality of Earnings **0.72** Generally the closer this is to 1, the higher the quality of Earnings

[Net Income/Net Cash from Operations]

Compare - Net Income with Net Cash Net Income **31%** Net Cash **39%** Net Cash is growing faster than Net Income. That normally is positive.

Net Income is growing **Net Cash is growing**

Cash Position per Share: **\$2.62** per share in cash beyond debt. **Great! This represents actual cash included in the price of each share of stock.**

[Net Cash / Shrs outstanding]

Offers price support in falling market if positive.

LT Debt to Equity Ratio: **6%** debt to equity. **Long-term Debt is in normal range**

[Long-term Debt / Total Equity]

Normal Long-term Debt -- Less than 25% debt.

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

Quick Ratio: **1.6 to 1** About 1:1 is normal. The higher the better.

[Cash+Markable Securities+Accts Rec. / Total Liabilities]

This is a relatively severe test of a company's liquidity and its ability to meet short-term obligations.

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]

Danger
Caution
Good
Very Good

Inventory Turnover Ratio: **2.8 to 1** The higher the ratio the better. Indicates quality merchandise & proper pricing.

[Cost of Sales / Inventory]

Also note the number of days Inventories are held before they become a product and sold (See "Inventories" above).

Plant Turnover Ratio: **5.9 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: \$ **1.41** 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.

1	\$60	Cash (see Balance Sheet)
2	\$14	Marketable Securities or Investments
3	\$65	Accounts Receivable this year
3	\$57	Accounts Receivable prior year
4	\$47	Inventories current year
4	\$47	Inventories prior year
5	\$211	Total Current Assets
6	\$55	This Yr. Total Property Plant & Equip.
6	\$51	Prior Yr. Total Property Plant & Equip.
7	\$85	Total Current Liabilities
8	\$13	Long-term Debt this year
8	\$11	Long-term Debt prior year
9	24	Common Shares Outstanding this Yr.
9	24	Common Shares Outstanding prior Yr.
10	\$224	Total Stockholders Equity
		(see Consolidated Statement of Earnings)
11	\$321	Total Sales or Revenues this Year
11	\$269	Total Sales or Revenues prior Year
11a	\$130	Cost of Sales this Year
11a	\$105	Cost of Sales prior Year
11b	\$59	Income before Taxes
11d	\$42	This Yr. Net Income
11d	\$32	Prior Yr. Net Income
11e		Total Interest Paid on Debt (from Ann. Rpt)
		Total Interest Coverage (from OPS)
		(see Statement of Cash Flows)
12	58	This Yr.-Net Cash provided by Operations
12	42	Prior Yr. -Net Cash provided by Operations
14	\$15	Acquisition of Property Plant & Equipment
13	\$3	Total Dividends paid (if any)
	\$19.20	Today's Price per Share
	04-Jul-03	Date of Price quote

CAUTION: Check for accuracy if using OPS data

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