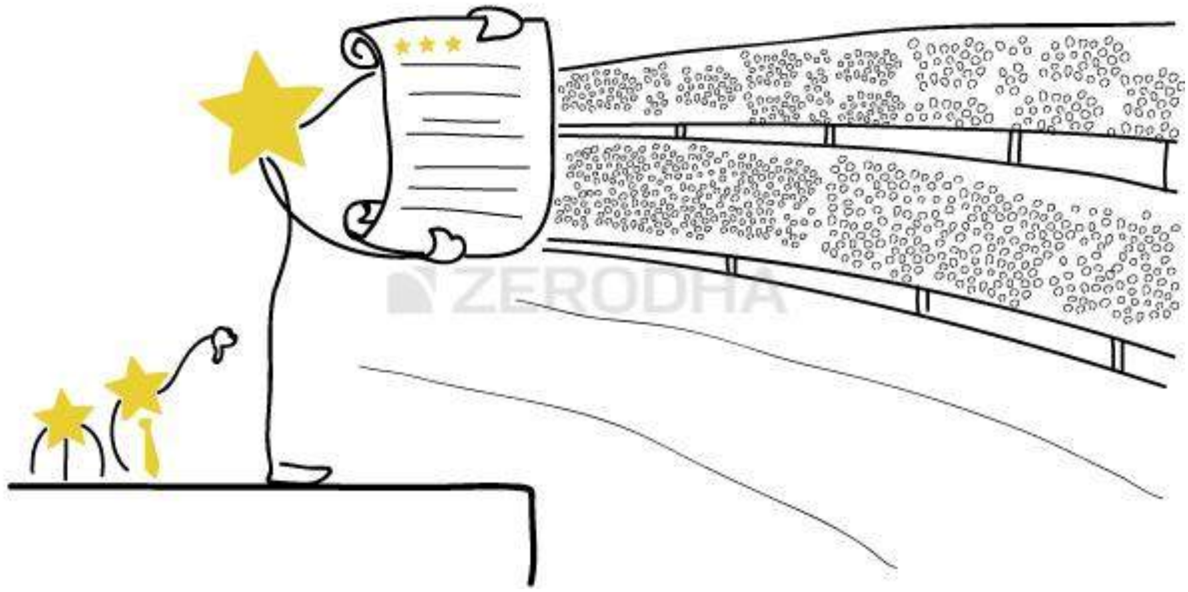
How to Read the Annual Report of a Company



3.1 – What is an Annual Report?

The annual report (AR) is a yearly publication by the company and is sent to the shareholders and other interested parties. The annual report is published by the end of the Financial Year, and all the data made available in the annual report is dated to 31st March. The AR is usually available on the company's website (in the investors section) as a PDF document or one can contact the company to get a hard copy of the same.

Since the annual report is published by the company, whatever is mentioned in the AR is assumed to be official. Hence, any misrepresentation of facts in the annual report can be held against the company. To give you a perspective, AR contains the auditor's certificates (signed, dated, and sealed) certifying the sanctity of the financial data included in the annual report.

Potential investors and the present shareholders are the primary audience for the annual report. Annual reports should provide the most pertinent information to an investor and should also communicate the company's primary message. For an investor, the annual report must be the default option to seek information about a company. Of course there are many media websites claiming to give the financial information about the company; however the investors should avoid seeking information from such sources. Remember the information is more reliable if we get it get it directly from the annual report.

Why would the media website misrepresent the company information you may ask? Well, they may not do it deliberately but they may be forced to do it due to other factors. For example the company may like to include 'depreciation' in the expense side of P&L, but the media website may like to include it under a separate header. While this would not impact the overall numbers, it does interrupt the overall sequencing of data.

3.2 – What to look for in an Annual Report?

The annual report has many sections that contain useful information about the company. One has to be careful while going through the annual report as there is a very thin line between the facts presented by the company and the marketing content that the company wants you to read.

Let us briefly go through the various sections of an annual report and understand what the company is trying to communicate in the AR. For the sake of illustration, I have taken the Annual Report of Amara Raja Batteries Limited, belonging to Financial Year 2013-2014. As you may know Amara Raja Batteries Limited manufactures automobile and industrial batteries. You can download ARBL's FY2014 AR from here (http://www.amararaja.co.in/annual_reports.asp)

Please remember, the objective of this chapter is to give you a brief orientation on how to read an annual report. Running through each and every page of an AR is not practical; however, I would like to share some insights into how I would personally read through an AR, and also help you understand what kind of information is required and what information we can ignore.

For a better understanding, I would urge you to download the Annual Report of ARBL and go through it simultaneously as we progress through this chapter.

ARBL's annual report contains the following 9 sections:

- Financial Highlights
- The Management Statement
- Management Discussion & Analysis
- 10 year Financial highlights
- Corporate Information
- Director's Report
- Report on Corporate governance
- Financial Section, and

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Note, no two annual reports are the same; they are all made to suite the company's requirement keeping in perspective the industry they operate in. However, some of the sections in the annual report are common across annual reports.

The first section in ARBL's AR is the **Financial Highlights**. Financial Highlights contains the bird's eye view on how the financials of the company looks for the year gone by. . The information in this section can be in the form of a table or a graphical display of data. This section of the annual report generally does a multi-year comparison of the operating and business metrics.

Here is the snapshot of the same:

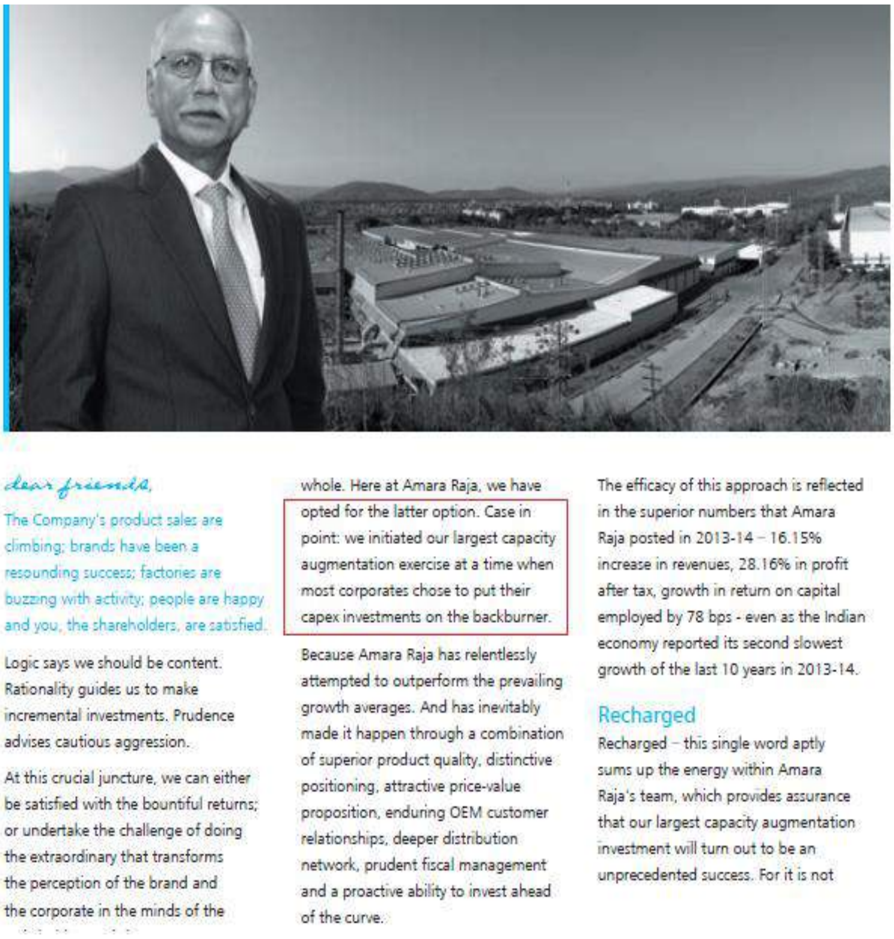
The details that you see in the Financial Highlights section are basically an extract from the company's financial statement. Along with the extracts, the company can also include a few financial ratios, which are calculated by the company itself. I briefly look through this section to get an overall idea, but I do not like to spend too much time on it. The reason for looking at this section briefly is that, I would anyway calculate these and many other ratios myself and while I do so, I would gain greater clarity on the company and its numbers. Needless to say, over the next few chapters we will understand how to read and understand the financial statements of the company and also how to calculate the financial ratios.

The next two sections i.e the '**Management Statement**' and '**Management Discussion & Analysis**' are quite important. I spend time going through these sections. Both these sections gives you a sense on what the management of the company has to say about their business and the industry in general. As an investor or as a potential investor in the company, every word mentioned in these sections is important. In fact some of the details related to the ‘Qualitative aspects’ (as discussed in chapter 2), can be found in these two sections of the AR.

In the ‘Management Statement’ (sometimes called the Chairman’s Message), the investor gets a perspective of how the man sitting right on top is thinking about his business. The content here is usually broad based and gives a sense on how the business is positioned. When I read through this section, I look at how realistic the management is. I am very keen to see if the company’s management has its feet on the ground. I also observe if they are transparent on discussing details on what went right and what went wrong for the business.

One example that I explicitly remember was reading through the chairman’s message of a well established tea manufacturing company. In his message, the chairman was talking about a revenue growth of nearly 10%, however the historical revenue numbers suggested that the company’s revenue was growing at a rate of 4-5%. Clearly in this context, the growth rate of 10% seemed like a celestial move. This also indicated to me that the man on top may not really be in sync with ground reality and hence I decided not to invest in the company. Retrospectively when I look back at my decision not to invest, it was probably the right decision.

Here is the snapshot of Amara Raja Batteries Limited; I have highlighted a small part that I think is interesting. I would encourage you to read through the entire message in the Annual Report.



dear friends,

The Company's product sales are climbing; brands have been a resounding success; factories are buzzing with activity; people are happy and you, the shareholders, are satisfied.

Logic says we should be content. Rationality guides us to make incremental investments. Prudence advises cautious aggression.

At this crucial juncture, we can either be satisfied with the bountiful returns; or undertake the challenge of doing the extraordinary that transforms the perception of the brand and the corporate in the minds of the

whole. Here at Amara Raja, we have opted for the latter option. Case in point: we initiated our largest capacity augmentation exercise at a time when most corporates chose to put their capex investments on the backburner.

Because Amara Raja has relentlessly attempted to outperform the prevailing growth averages. And has inevitably made it happen through a combination of superior product quality, distinctive positioning, attractive price-value proposition, enduring OEM customer relationships, deeper distribution network, prudent fiscal management and a proactive ability to invest ahead of the curve.

The efficacy of this approach is reflected in the superior numbers that Amara Raja posted in 2013-14 – 16.15% increase in revenues, 28.16% in profit after tax, growth in return on capital employed by 78 bps - even as the Indian economy reported its second slowest growth of the last 10 years in 2013-14.

Recharged

Recharged – this single word aptly sums up the energy within Amara Raja's team, which provides assurance that our largest capacity augmentation investment will turn out to be an unprecedented success. For it is not

Moving ahead, the next section is the '**Management Discussion & Analysis**' or 'MD&A'. This according to me is perhaps one of the most important sections in the whole of AR. The most standard way for any company to start this section is by talking about the macro trends in the economy. They discuss the overall economic activity of the country and the business sentiment across the corporate world. If the company has high exposure to exports, they even talk about global economic and business sentiment.

ARBL has both exports and domestic business interest; hence they discuss both these angles in their AR. See the snapshot below:

Global economy
The global economy remain subdued as global GDP growth decelerated for the third year – 3.9% in 2011 to 3.1% in 2012 and 3% in 2013. Most developed economies addressed the reality through appropriate remedial fiscal policy action. Besides, a number of emerging economies, which had already experienced a debilitating slowdown in the past two years, encountered new domestic and international headwinds during this period.

Prospects: Looking ahead, global growth is projected to strengthen to 3.6% in 2014 and 3.9% in 2015 (Source: IMF April 2014). Global activity is expected to improve during 2014-15, with much of the impetus coming from advanced economies. Many emerging market economies account for more than two-thirds of global growth and their output growth is likely to be lifted by exports to advanced economies.

Challenge: Global recovery is still fragile despite improved prospects with significant downside risks. Among old risks, those related to emerging market economies increased. According to the Global Financial Stability Report, rapid normalisation of the American monetary policy or renewed bouts of high risk aversion on the part of investors could result in further pain *(Source: IMF, April 2014).*

ARBL’s view on the Indian economy:

Indian economy

India's economic growth of 4.7% in 2013-14 was marginally higher than the previous year due to an improved performance in the agriculture and allied sectors.

The slowdown was primarily due to an unsupportive external environment, regulatory policy logjam, structural constraints and inflation. Despite these challenges, there were positives which provided a foundation for resurgence:

The current account deficit contracted; the fiscal deficit target was met

India implemented substantive measures to narrow external and fiscal imbalances, tighten monetary policy, move forward on structural reforms and address market volatility to reduce vulnerability

India built upon its foreign exchange reserves

The Indian economy is placed better than what it was in 2013. A dynamic government at the Centre strengthens optimism of robust economic growth, which is projected at 5.6% in 2014, rising to 6.0% in 2015 (Source: RBI).

User sectors

Telecom: India's telecom industry posted a 10.1% revenue growth in 2013-14 from 8.6% in the previous fiscal despite intense competition and call rates declining to an all-time low. The improvement was largely a result of growth in the wireless subscriber base, reduced churn levels and an improvement in revenue realisation.

More importantly, 2013-14 will be regarded as a transformational year for the industry. The uncertainty of the previous years ended with fresh spectrum auctions taking place. The Department of Telecom, Government of India, announced significant initiatives - revision of the 'tower rollout policy' and the 'mergers and acquisitions

Chilling plant cooling towers
New plant at Nunegundlapalle village

Following this the companies usually talk about the trends in the industry and what they expect for the year ahead. This is an important section as we can understand what the company perceives as threats and opportunities in the industry. Most importantly I read through this, and also compare it with its peers to understand if the company has any advantage over its peers.

For example, if Amara Raja Batteries limited is a company of interest to me, I would read through this part of the AR and also would read through what Exide Batteries Limited has to say in their AR.

Remember until this point the discussion in the Management Discussion & Analysis is broad based and generic (global economy, domestic economy, and industry trends). However going forward, the company would discuss various aspects related to its business. It talks about how the business had performed across various divisions, how did it fare in comparison to the previous year etc. The company in fact gives out specific numbers in this section.

Here is a snapshot of the same:

Overview	Products	Distribution network	Customers	Niche features
Commenced operations in 2000 with technology from Johnson Controls Inc. USA **Manufacturing** facility is QS-9000, ISO-14001 and TS- 16949 certified	**Passenger cars:** Amaron® Pro, Amaron® Flo, Amaron® Go, Amaron® Black and Amaron® Fresh **Commercial vehicles:** Amaron® Hiway **Tractors:** Amaron® Harvest **Two-wheelers:** Amaron Pro Bike Rider™	**Amaron® network** comprises 294 franchised distributors, including 25,000-plus retailers **PowerZone™ network** comprises 1,100 retail outlets ensuring widespread semi-urban and rural presence	**Major OEM customers:** Ford, Maruti Suzuki, Hyundai, Honda, M&M, Tata, Volvo, Eicher, Daimler Benz, Tafe Tractors, Isuzu Motors among others **Major private label customers:** Bosch, Lucas, Cummins and AC Delco **Leading player** in the aftermarket segment among four-wheelers	**Battery** supplier to the entire 'Comfort Delgro' taxi fleet in Singapore **100%** share of business with Ford India and Daimler Benz **100%** share of business in Maruti A-Star exports and Hyundai EON **First** supplier of batteries to Mahindra and Mahindra for Scorpio micro hybrid vehicles **First** to introduce zero maintenance four-wheeler batteries and VRLA two-wheeler batteries **First** to provide extended warranties to consumers

Some companies even discuss their guidelines and strategies for the year ahead across the various verticals they operate in. Do have a look at the snapshot below:

Rising rural income: The government shifted its focus towards rural sector development. The government's crop price support policy over the last five years has led to higher rural incomes.

Aftermarket

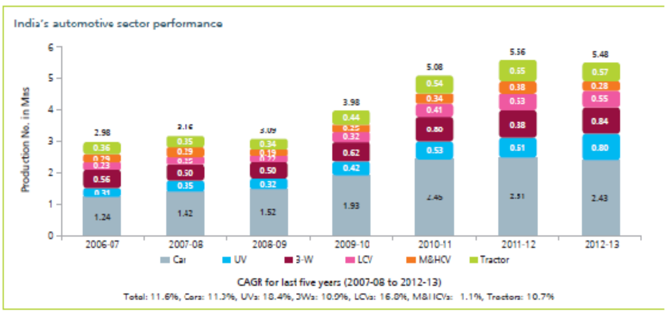
Every vehicle added on Indian roads creates an aftermarket opportunity as batteries need to be changed every few years. So while OE demand extends only to assembly, the aftermarket demand stays upbeat across useful asset life, making the aftermarket a significantly larger opportunity. And while the OE market may experience volatility consequent to economic and business cycles, the aftermarket growth rate remains relatively stable.

Since the battery is a critical component in every automobile (including a two-wheeler), long life and reliability are the most important factors influencing purchase. With the organised sector providing a superior value-proposition, there is an increasing shift towards branded batteries in the aftermarket segment.

Amara Raja's strategy

Aftermarket: The Company's significant presence in the aftermarket segment de-risks it from sectoral cyclicality. Going forward, the Company will continue to strengthen its distribution network by entering areas where its penetration is low, filling gaps in its product range and ensuring supply chain efficiency. Moreover, the Company will continue to invest in brand promotion and ground-level initiatives to develop a stronger bond with customers, retailers and distributors.

OE market: While the aftermarket is the key revenue earner, the Company is also working to forge stronger relationships with leading and reputed OE players in the automotive market, which will increase its brand preference at the time of replacement.



(Source: SIAM)

After discussing these in 'Management Discussion & Analysis' the annual report includes a series of other reports such as – Human Resources report, R&D report, Technology report etc. Each of these reports are important in the context of the industry the company operates in. For example, if I am reading through a manufacturing company annual report, I would be particularly interested in the human resources report to understand if the company has any labor issues. If there are serious signs of labor issues then it could potentially lead to the factory being shut down, which is not good for the company's shareholders.

3.3 – The Financial Statements

Finally, the last section of the AR contains the financial statements of the company. As you would agree, the financial statements are perhaps one of the most important aspects of an Annual Report. There are three financial statements that the company will present namely:

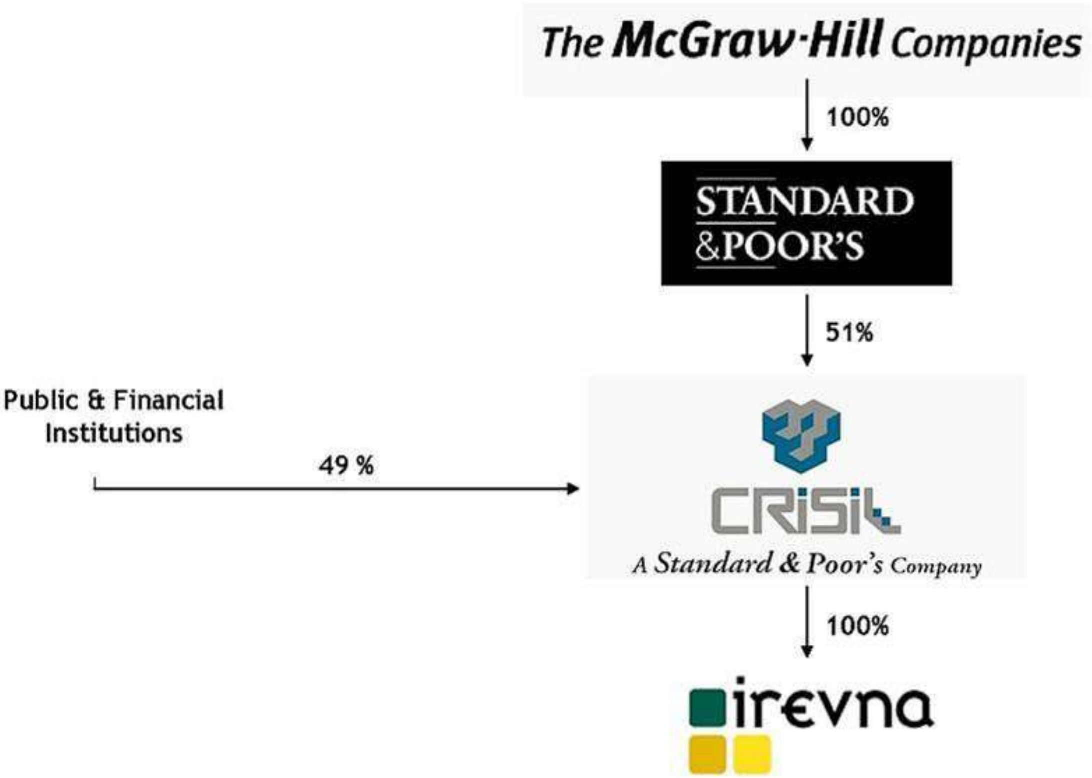
1. The Profit and Loss statement
2. The Balance Sheet and
3. The Cash flow statement

We will understand each of these statements in detail over the next few chapters. However at this stage it is important to understand that the financial statements come in two forms.

1. Standalone financial statement or simply standalone numbers and
2. Consolidated financial statement or simply consolidated numbers

To understand the difference between standalone and consolidated numbers, we need to understand the structure of a company.

Typically, a well established company has many subsidiaries. These companies also act as a holding company for several other well established companies. To help you understand this better, I have taken the example of CRISIL Limited's shareholding structure. You can find the same in CRISIL's annual report. As you may know, CRISIL is an Indian company with a major focus on corporate credit rating services.



As you can see in the above share holding structure:

1. Standard & Poor's (S&P), a US based rating agency holds a 51% stake in CRISIL. Hence S&P is the 'Holding company' or the 'Promoter' of CRISIL
2. The balance 49% of shares of CRISIL is held by Public and other Financial institutions
3. However, S&P itself is 100% subsidiary of another company called 'The McGraw-Hill Companies'
1. This means McGraw Hill fully owns S&P, and S&P owns 51% of CRISIL
4. Further, CRISIL itself fully owns (100% shareholding) another company called 'Irevna'.

Keeping the above in perspective, think about this hypothetical situation. Assume, for the financial year 2014, CRISIL makes a loss of Rs.1000 Crs and Irevna, its 100% subsidiary makes a profit of Rs.700 Crs. What do you would be the overall profitability of CRISIL?

Well, this is quite simple – CRISIL on its own made a loss of Rs.1000 Crs, but its subsidiary Irevna made a profit of Rs.700 Crs, hence the overall P&L of CRISIL is (Rs.1000 Crs) + Rs.700 Crs = (Rs.300 Crs).

Thanks to its subsidiary, CRISIL's loss is reduced to Rs.300 Crs as opposed to a massive loss of Rs.1000 Crs. Another way to look at it is, CRISIL on a **standalone** basis made a loss of Rs.1000 Crs, but on a **consolidated** basis made a loss of Rs.300 Crs.

Hence, Standalone Financial statements represent the standalone numbers/ financials of the company itself and do not include the financials of its subsidiaries. However the consolidated numbers includes the companies (i.e.standalone financials) and its subsidiaries financial statements.

I personally prefer to look through the consolidated financial statements as it gives a better representation of the company's financial position.

3.4 – Schedules of Financial Statements

When the company reports its financial statements, they usually report the full statement in the beginning and then follow it up with a detailed explanation.

Have a look at the snapshot of one of ARBL's financial statement (balance sheet):

Balance Sheet as at March 31, 2014

₹ million

Particulars	Note No.	As at March 31, 2014		As at March 31, 2013	
EQUITY AND LIABILITIES					
Shareholders' funds					
Share capital	2	170.81		170.81	
Reserves and surplus	3	13,456.20		10,427.33	
			13,627.01		10,598.14
Non-current liabilities					
Long-term borrowings	4	759.47		773.13	
Deferred tax liabilities (net)	5	301.33		195.09	
Long-term provisions	6	369.57		376.41	
			1,430.37		1,344.63
Current liabilities					
Short-term borrowings	7	83.83		98.63	
Trade payables	8	1,277.79		1,362.84	
Other current liabilities	9	2,156.68		1,807.26	
Short-term provisions	6	2,818.73		2,493.20	
			6,337.03		5,761.93
Total			21,394.41		17,704.70

Each particular in the financial statement is referred to as the line item. For example the first line item in the Balance Sheet (under Equity and Liability) is the share capital (as pointed out by the green arrow). If you notice, there is a note number associated with share capital. These are called the 'Schedules' related to the financial statement. Looking into the above statement, ARBL states that the share capital stands at Rs.17.081 Crs (or Rs.170.81 Million). As an investor I obviously would be interested to know how ARBL arrived at Rs.17.081 Crs as their share capital. To figure this out, one needs to look into the associated schedule (note number 2). Please look at the snapshot below:

Notes forming part of the Financial Statements

NOTE 2: SHARE CAPITAL

₹ million

Particulars	As at March 31, 2014	As at March 31, 2013
Equity share capital		
Authorised		
200,000,000 Equity shares of ₹1 each	200.00	200.00
Issued	-	-
175,028,500 Equity shares of ₹1 each	175.03	175.03
Subscribed and paid up	-	-
170,812,500 Equity shares of ₹1 each	170.81	170.81
Total	170.81	170.81

Of course, considering you may be new to financial statements, jargon's like share capital make not make much sense. However the financial statements are extremely simple to understand, and over the next few chapters you will understand how to read the financial statements and make sense of it. But for now do remember that the main financial statement gives you the summary and the associated schedules give the details pertaining to each line item.

Key takeaways from this chapter

1. The Annual Report (AR) of a company is an official communication from the company to its investors and other stakeholders
2. The AR is the best source to get information about the company; hence AR should be the default choice for the investor to source company related information
3. The AR contains many sections, with each section highlighting certain aspect of the business
4. The AR is also the best source to get information related to the qualitative aspects of the company
5. The management discussion and analysis is one of the most important sections in the AR. It has the management's perspective on the overall economy of the country, their outlook on the industry they operate in for the year gone by (what went right and what went wrong), and what they foresee for the year ahead
6. The AR contains three financial statements – Profit & Loss statement, Balance Sheet, and Cash Flow statement
7. The standalone statement contains the financial numbers of only the company in consideration. However the consolidated numbers contains the company and its subsidiaries financial numbers.