The Investor's Guide to Understanding Accounts

10 crunch questions to ask before investing in a company

Robert Leach

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At the time of writing this book, the author held small shareholdings in Abbey National, AstraZeneca, Atlantic Caspian, Bolton Group, BP, BT, Cadbury Schweppes, Chorion, Crown Sports, GlaxoSmithKline, Lloyds TSB, National Grid, Pharmagene, PlaneStation, Prudential, Pursuit Dynamics, Royal Bank of Scotland, Sainsbury, Scottish & Newcastle, SiRViS iT, Tesco, Urbium, and Wilshaw.

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PART

I

Why you cannot afford to ignore company accounts

Introduction

Company accounts and the annual report tell you:

- how much profit the company has made
- how it made that profit
- how much the company is worth
- how the directors view the year
- what the directors expect for the future

and much more, all of which can help you to decide whether to invest.

However, sifting through the mass of information requires knowledge of what to look for, how to use it when found, and what it all means. This book aims to help you understand how to analyse numbers and how to apply that analysis to investment decisions.

By law, all shareholders must receive a copy of the company's accounts. For larger companies these are often printed in glossy A4 format, almost like a brochure, with the front section containing the reports, and the accounts starting halfway through. Much of this book is concerned with explaining those numbers, including a basic tutorial at the start of Part IV. However the written reports are also important, and therefore form part of the discussion.

Numbers in accounts rarely mean much on their own. A net profit before tax of £200,000 or a share price of 50p tells you nothing about whether the company represents a good investment.

First, you must make sure that you are looking at the right accounts. You should be looking at **consolidated accounts**. Almost all businesses are now structured as a holding company which owns subsidiaries, some of which may themselves own sub-subsidiaries. Consolidated accounts treat all this group of companies as if they were one single company. It is in this group that you have invested. The accounts for the holding company itself must be published by law, but you can generally ignore them. Where accounts have columns or separate pages marked 'company' and 'consolidated' (or 'group'), it is the latter in which you are interested.

The main method for interpreting accounts is the **ratio**, though sometimes you need to understand about the basic figures. The accounts are the raw material for which ratios act as the tools. Which ratios you use depends on the company and what you wish to check. Just as a toolkit contains many tools only some of which you use for any particular job, so this book contains a kit of ratios, only some of which are needed to consider particular companies.

A ratio is simply one figure in the accounts divided by another, such as dividing profit by number of shares to give earnings per share. The answer rarely means much on its own. In most cases, the figure must be compared with similar companies.

Sometimes a ratio becomes one of the figures in another ratio, such as price/earnings ratio when the share price is divided by earnings per share.

Some ratios are in such common use that companies and providers of stock information calculate them for you. Common ratios include:

- gearing
- earnings per share
- dividend cover
- price/earnings ratio
- dividend yield

Other ratios are widely used in the accounting profession to understand the accounts. These include:

- gross margin
- acid test

These ratios and others are explained and discussed in detail later in the book.

Understanding the ratios

A ratio is not an end in itself, but a means to an end, namely forming an opinion about the company from its accounts.

To assist in this process, the major part of this book is structured under ten basic questions which all investors should ask about a company:

1.	Is the company growing?
2.	Are costs under control?
3.	Does it make a profit?
4.	How much cash does it have?
5.	Is its market value supported by assets?
6.	Is it using debt wisely?
7.	Are there any hidden nasties?
8.	Is management good enough?
9.	Can I expect a reliable income?
10.	Are there any threats to my interests?

The ratios and other comments under each question will help you come to an answer for each question.

For management there are obvious answers wanted for each question (no for 7 and 10, and yes for the rest). However there are no obvious answers for investors.

The best share investment in the world is in a company which you think will perform better than the market thinks.

Even if you conclude that a company is likely to perform badly, it could still be a good investment if the market thinks that it will perform even worse.

Investment analysts are always at a disadvantage in that they must rely on historic data which may not prove a reliable indicator for the future.

However remember that you are trying to find shares which you think will perform better than the market thinks they will. Both you and the market have the same disadvantage in having to rely on historic data. So, to some extent, the disadvantages cancel each other out.

The ratios and other comments in this book are intended to help you determine how a company is likely to perform, and how the market expects it to perform.

However understanding accounts is more than calculating a few ratios. It is first necessary to narrow down your choice of company, as suggested in Section 2.1. It is recommended that you consider companies in three stages:

- review the accounts, using ratios and comparators;
- then read the narrative reports to compare your conclusions and seek explanations;
- then read coverage in the press, newsletters and on websites to compare your conclusions against other commentators.

Sometimes the accounts seem to be saying one thing when the reality is different. This book contains examples where the reality is different from the initial perception gained by following ratios alone.

It is good practice to identify three reasons for investing in a particular company. When you have identified those reasons, write them down. Review the company periodically. If you still believe in those reasons, continue holding the share. Only sell when you no longer believe the reasons.

You can always gain free hands-on experience by operating a dummy portfolio. You go through the process of share picking without buying the shares. You can monitor the shares as if you had bought them, to give you experience of how well you can pick them.

All this is in addition to the normal good advice about investing in shares:

Investing in shares - general advice

- only invest in what you understand;
- do not borrow money to invest;
- do not invest money in shares if you need it for a specific date (such as for buying a house or paying for a holiday);
- be prepared to see your investments go down sometimes;
- monitor share performance;
- be prepared to sell to take profits and cut losses;
- do not grieve over losses. If your emotional constitution cannot stand losses, buy National Savings instead and give this book to the Oxfam shop;
- run a dummy portfolio if you have not invested before, and then start a real portfolio cautiously, not using all your capital;
- do not feel possessive or sentimental about your shares. If it is time to sell them, do so;
- remember shares have not made you a profit until you have received a cheque from the stockbroker;
- never believe that you are a whizz investor. You should outperform unit trusts, but only because you are not paying their charges.

What business?

Ratios are of limited value by themselves. It is necessary to understand the nature of the business as what may be a healthy ratio for a supermarket can be an unhealthy ratio for a construction company.

For this reason, Part III makes some observations about particular trade sectors.

Although much of the book deals with big companies, the principles apply equally to small companies. It is here that research can pay off. All the big companies are analysed by at least 50 analysts every day. It is among the unanalysed small and medium-sized companies that you may find a real bargain. Peter Lynch, a successful money manager, made a fortune from investing in an obscure hosiery company called Hanes in the 1970s when his wife raved about the tights they made.

Reliability of accounts

You also need to consider the reliability of the accounts, particularly since the Enron scandal.

Accountancy is an art not a science. The figures you read are, to some extent, reflections of opinion as well as fact. Part IV of the book considers the reliability of accounts, and how you may be able to detect anything suspicious. Part V looks at how you may obtain supporting information.

You should also appreciate that companies do not live in a vacuum but in a world where politicians make decisions, events happen, values and fashions change and economies perform with the same limited expectations as the weather. This aspect is considered in general in Section 2.10, and in relation to specific sectors in Part III. However no such consideration can ever be complete. In general, external economic factors affect companies similarly and therefore may often be ignored in some comparisons.

So should I invest in shares at all?

A share is the part ownership of a business. When you own a share in Sainsbury's, you own part of the company. With the other shareholders, you own the whole company. That means that some of the profit on every tin of baked beans sold belongs to you, and will come to you, either as a dividend or an increase in the share price.

The accounts are the record of how well the managers have run the business for you; whether they have been good stewards of your investment.

Shares are the ideal long-term investment for the private individual. They provide two sorts of income – dividends and capital growth; they are simple to understand and to monitor, and they provide the highest levels of return and the lowest level of cost.

This may seem a strange claim when the stock market has lost half its value in the three years to 2002. However even the depressed market cannot stop shares being long-term value. Someone given £130 worth of free shares in Abbey National (now called Abbey) in 1988 would find that they were worth "only" £420 in 2003, having had £75 in dividends in 2002. Such shares would have been given to someone with at least £200 in an account in 1988, worth about

£250 in 2003. Abbey National was regarded as one of the worst performing shares in 2003, as its value fell by more than two-thirds from a peak of £14 to just over £4. Even for such a poor performing share in such a poor performing market, the investor has an annual income of over 50% his original investment and has seen that investment more than treble.

Another way of considering shares in a bear market is to consider what happened to houses in the recession of 1991/92. Some property prices fell by 25% or more, as many house-owners faced negative equity – the balance owed on the mortgage exceeding the value of the house. If those property owners held their nerve and sat tight, they could have seen their property value treble in the next ten years.

The stock market is not always volatile. It was largely static between 1938 and 1952, and between 1968 and 1982. It crashed between 1972 and 1974, in 1987, and between 1999 and 2003.

For shares, this can be seen as a law of economics. Wealth is simply the capitalisation of products and services, as represented by services and tangible products. The commercial sector is where this wealth is created. Shares are the wellspring of wealth. Some prefer unit trusts as a safer investment. All that the fund managers do is to invest the funds in shares and cream off some profit. The wealth is still coming from the same stream, but further from the spring. That is why pensions, unit trusts, life policies and many other forms of investment have also done badly during the bear market.

In the year to April 1998, the London stock market rose by 44%, but the average increase in unit trusts was a mere 12%. Only two out of 1588 funds out-performed that market. Over three-quarters of managed funds routinely fail even to match the market, despite the hype about star fund managers.

Even those investments which appear unrelated to shares – such as property, gilts and gold – have their return indirectly funded by shares, as they provide both the benchmark to measure such investments and the wealth to buy them.

Aim of this book

There have been several experiments where a random selection of shares, chosen by such methods as throwing darts at *The Financial Times*, has been measured against unit trusts. Over a long term, a minimum of ten years, such a random selection consistently outperforms managed funds.

This is simply because of fees. The combination of capital growth and dividends can produce income growth of 12% from shares, even including periods of bear markets. Suppose a fund manager takes a modest 1% a year in commission, so that you only receive 11%. Over 30 years, £100 will have grown to £3,000 at 12% but only to £2,300 at 11%.

Fund managers find it hard to beat the market, simply because they are the market. Some managers perform better than others, but much of such variation can be put down to random distribution rather than to any skill. But over a long period, none of them can outperform the market sufficiently to make up for the lost return represented by their fees.

You can beat the market because you can be more informed, more adventurous and pay less in fees. This book will not guarantee that you will succeed, but should help the process. Good luck.

Robert Leach

PART

II

The 10 tests that a set of accounts must pass

1. Is the company growing?
2. Are costs under control?
3. Does it make a profit?
4. How much cash does it have?
5. Is its market value supported by assets?
6. Is it using debt wisely?
7. Are there any hidden nasties?
8. Is management good enough?
9. Can I expect a reliable income?
10. Are there any threats to my interests?

Section

2.1 Is the company growing?

Relevant to
All fundamental investors

Underlying worry
'Is the company selling a product/service that people want to buy?'

Sources of sales

What does the company do?

This is the first question every investor must ask about a potential investee. You cannot make any sensible investment decision, nor understand the accounts, until you have a clear answer in your mind.

Many times, companies have substantial interests in related businesses. Marks & Spencer does not just sell knickers and marmalade. It has a substantial and growing business in the financial sector. Tesco has an insurance business which frequently comes top in rates for life insurance. Sainsbury's owns a bank.

Suppose you are considering investing in Whitbread, which *The Financial Times* lists under 'leisure and hotels'. Do you know what the company does? Logging on to its website, which has an excellent section for investors, you can see that its main businesses are:

- Whitbread Hotels (the most rooms for any hotel business);
- Travel Inn;
- Pub chains;
- Beefeater restaurants;
- Pizza Hut (joint venture);
- Costa coffee shops;
- David Lloyd Leisure (sports centres);
- Britvic (soft drinks).

Immediately you can start to identify possible good investments. Where do you eat? Who owned the hotel you chose for your last holiday? Did you have a good meal at Beefeater or Pizza Hut? What do your friends think of them? Where are Britvic drinks sold?

Sometimes companies have odd combinations of activities. Burndee Investments sells fixed caravans and ladies' tights. Cosalt sells lifejackets, fish nets and school uniforms. Chorion exploited rights in children's books and ran nightclubs, until the latter was demerged into Urbium. Initial Link, the overnight and same-day parcel service, is owned by Rentokil, the pest control company.

Many companies in various sectors own substantial amounts of property, which may not be obvious from your experience as a consumer of their products and services, but which significantly changes their investment profile.

Conversely, some companies may appear to be bigger than they are. Pubs may be branded with the name of a brewer but be owned by a franchisee.

Plain common sense in this area can be valuable. If a company says it is marketing a popular soap, go to the chemist and see how many are being sold. Indeed, see if you find it on sale. Investors can become deluded. During the Wall Street Crash in 1929, many individuals continued to pour money into companies even though they knew they were laying off staff. From its low in 1932, the American stock market did not recover until 1954. In 1991, investors continued to buy shares in Polly Peck without wondering how such spectacular profits were made from tinned pineapple and cardboard boxes.

Above all, do not buy shares just because everyone else is. In 1719 people bought shares in South Sea Company which soared in price from £100 to £1,050 even though it did nothing for eight years. It crashed in 1720. Something similar happened 280 years later with Boo.com (see Part III).

If you want to invest in interesting companies there are still some pioneering innovative ideas. Stanelco is developing a packet of dried soup where the packet dissolves in the water with the soup. Syence Skin Care develops cosmetics acceptable under Islamic law.

Sometimes companies change their scope. Wiggins Group moved from being a property company to an out-of-town airport operator, and changed its name to Planestation. London & Boston Investments has moved from investments to covert surveillance. Companies can move within their sector, such as when Haynes Publishing diversified from motor handbooks to a sex manual. At least they both involve stripping down to fit bodywork together.

And sometimes it is difficult to know in what you are investing. In the early 2000s, troubled engineering company Invensys was forced to sell so many businesses to reduce its debt, that it was difficult for investors to know what would be left.

How do I start choosing companies?

The London Stock Exchange currently lists 1,770 UK companies and 430 overseas companies. These are the biggest of the 12,400 public companies in the

UK (in March 2002) which in turn were the biggest of the 1,491,500 registered companies. You need a way to narrow the field quickly.

Only buy shares in companies you understand. If you are an engineer or chemist consider engineering companies or chemical companies. Here is a quote about future prospects from the 2002 accounts of Shire Pharmaceuticals:

> ADDERALL XR is now well established as a leading once-daily ADHD treatment and, in its first year of launch, has become the preferred choice of top-prescribing physicians for the patients in the US. In conjunction with continued growth of our key revenue streams, including the relaunch of CARBATROL, and three pending product registrations (ADDERALL XR – adults in the US, FOSRENOL (lanthanum carbonate) – US/EU, XAGRID – EU), our sales and marketing organisation is poised to continue driving the performance of Shire's revenues.

If you have a clue what this means, you can make a judgment about whether it is worth investing in it. Exactly how you apply your knowledge to different types of business is explained in Part III.

In 18th century London it was possible to buy shares in companies for transmuting animals, curing lunatics, melting sawdust, perpetual motion machines and "a company for carrying on an undertaking of great advantage, but nobody to know what it is". The last company raised £2,000 in five hours selling shares at £2. The law on company prospectuses is tighter now.

Another good starting point is to look at what is selling in supermarkets, what products your family and friends enthuse about, what comments friends make about the companies they work for, and which company is building new premises. You already know these companies have the potential for success. Some analysis on their accounts will assist you in deciding whether to invest. Always start by asking "what does the company do?". If it sells widgets, find out what a widget is.

If the company serves consumers, you can try dealing with the company. Do you get good service when you call, or do you get a machine asking you to press buttons on the telephone before a voice tells you that your call is important, so someone will speak to you in 12 minutes? Companies tend to treat customers and investors the same way. Consider this quote from *Investors Chronicle* of 13 February 2004, "With Greene King pubs, punters always know they can expect honest fare in traditional surroundings. And the offering to investors is similarly solid and dependable."

Some companies you may reject on ethical grounds. Between 10% and 25% of the market is usually excluded by ethical investors, depending on their exact criteria.

Look at the website. It should promote both the company's products or services *and* have investor information readily available.

Then obtain the annual report; Appendix 1 explains how. First impressions are usually right. The report is, literally, selling the company. A good example is Reckitt Benckiser accounts for 2000. The cover is attractive (particularly as the picture is just a pile of plastic bottle tops) with the punchy slogan "over 9 million products sold every day". The inside cover shows these products: Dettol, Lysol, Vanish, Resolve, Calgon, Finish, Electrasol, Veet etc. The opposite page gives financial highlights: net revenue, operating profit, profit before tax, profit after tax, diluted earnings per share, and dividend per share.

This is a good combination of sales and finance, which drive every successful business. You should be wary of companies which talk only of their products or only of finance. And do not touch companies which have more than three photographs of any director. The opening pages should explain what the company is about. The official narrative reports usually follow next, before the accounts. This in itself does not mean that Reckitt Benckiser is a good share to buy, but it does mean that you should seriously consider the company.

Only when you have filtered down the companies are you ready to start analysing the accounts. You will find that Reckitt Benckiser has improved operating profit to 18.3%, but this is still behind competitors Colgate Palmolive at 21.9% and Proctor & Gamble at 20%, but Reckitt has set itself a growth target of 5% a year. These are the key questions for a household products company, but we are racing ahead.

How does the company compare?

Each business sector has its own particular financial profile, as explained in Part III.

The problems of intra-sector comparison can be avoided by comparing companies with their peers in the same sector. For example, BAE Systems is the fourth largest defence contractor in the world, but from 1999 to 2004 it underperformed the market by 53%. The company can get the orders but cannot get profits from them. If that continues, there may be pressure for management change.

This does not make BAE a poor investment, but it means that you would have to form the opinion that the company will improve more than the market thinks it will.

What are the company's different sales divisions?

It should be possible from the report to the accounts to determine the various activities of the company.

Few companies venture into a completely new area. One rare exception was when Sketchley diversified from dry cleaning into maintaining telegraph poles. Otherwise, the divisions are usually related in that one division will not only generate its own profit but contribute to the profits of other divisions. A common example is a store offering financial products which not only make their own profit, but also encourage customers to buy the store's products.

An investor should look for this synergy between divisions.

In the 1970s, diversification was a fashion among businesses. There was a saying "if you want a pint of milk, buy a cow", and so companies sought to replace contractors with in-house facilities. Instead of hiring cleaners, the company would set up a cleaning company to clean its own premises and offer the service to other companies. In general, this amount of diversification proved too much for a single management. The more obscure and small bits typically were poorly managed and of uneconomical scale. So the fashion swung back to 'zero-basing', which means sticking to what the company knows. You should consider how far the company has diversified and how far it is zero-based.

Which parts of the business are growing and which are contracting?

What is segmental reporting?

Companies are required to provide segmental reporting under statement of standard accounting practice SSAP 25, issued in June 1990.

The different parts of a business for which segmental reporting is appropriate are determined either as a geographical area or according to the class of business. So a company operating in the US and UK may provide segmental reports for each country. A company selling products and financial services may provide segmental reports for each activity.

For most companies, it is possible to analyse trading activities into an almost infinite number of segments. The standard therefore restricts disclosure to reportable segments. The basic requirement of a reportable segment is that it:

- differs significantly from other sectors in terms of return, risk, growth or development potential for investors;
- represents at least 10% of the turnover, profits or assets of the company;
- is distinguished from other segments by geographical area or class of business.

For each segment, the accounts must disclose:

- turnover;
- 'result' (broadly net profit before interest and tax);
- costs (with an appropriate apportionment of common costs);
- net assets; and
- associated undertakings.

Where a company provides segmental reporting it must analyse its whole business into segments. So the totals for each segment must equal the total shown in the consolidated accounts.

Segmental reporting should be seen as an adjunct to the directors' report. This report will talk of growth and decline in its various markets. Look to see if the directors regard the market as sufficiently discrete to justify a segmental report. Some simple analysis, such as comparing “results” with previous years will see how credible is the directors’ view.

Insurance company Prudential is an example where segmental reporting is useful. Its 2003 accounts show that sales rose by 8% in Asia but fell by 30% in the USA.

What are its discontinued operations and why were they discontinued?

Discontinued operations must be accounted for separately in the profit and loss account. However the law does not state that details must be given of the discontinued operations.

Where this entry appears in the profit and loss account, and is for a significant amount, you should look elsewhere in the accounts to identify which operations have been discontinued, and why.

You should consider the information offered critically. Is this simply an activity which has come to the end of its natural life, or is better supplied in another way? Reports rarely ask why, if it is now considered necessary to “concentrate on core activities” (a common excuse), did they buy the business in the first place.

One answer is that a company only wanted part of the business. When Racal bought Decca, it wanted the navigation side. The record business was sold.

Are sales geographically spread?

In business, geography is considered at two main levels. The internal level looks at how well the business supplies the home market. The external level looks at its exports.

Geographical spread may be indicated by segmental reporting, as explained above. However a more subtle indication may be given by looking at the group structure and seeing what companies there are for specific countries. Most businesses find it convenient to set up a subsidiary company in each territory where they operate. It can be revealing to see what is said about them in the directors’ report and other text.

Sometimes companies deliberately withhold this information. Calibration company Renishaw keeps quiet about what it sells, where and when, to keep competitors in the dark. However half-yearly accounts show that the company makes most of its profits in the second half of the year.

Is there a seasonal sales pattern?

Businesses are more seasonal than is generally realised. For example, about one third of retail jewellery is sold in the four weeks before Christmas.

For the long term, you need to consider what the company is doing about seasonality. Is it diversifying into off-season activities? A classic example was Wall's which sold ice cream in summer and hot dogs in winter.

Seasonality also needs to be considered in terms of when the year-end is, as it impacts on the balance sheet. If a company prepares its balance sheet towards the end of its busy season, it will have plenty of cash and a healthier looking balance sheet which may not properly represent its general working condition.

A good indication of seasonality comes from looking at 'cash' in current assets on the balance sheet, and 'interest paid' in the profit and loss account. Some businesses prepare their balance sheet just after their main season when they have the most cash. There are good practical reasons why a company wants to prepare its financial statements promptly after its busiest season, so that in itself should not be regarded as suspicious. However it can hide the fact that the company has lean months. A significant figure for interest paid when a company shows plenty of cash is a good indication of lean seasons. You then need to consider whether the company has sufficient resources to continue through the next lean season.

Seasonality relates to the business, not to the everyday calendar. So clothing wholesalers will be selling summer clothes in winter, and winter clothes in summer. Winter clothes are more expensive and therefore generate more revenue.

Business focus

Historically, has it stuck to its knitting?

Any departure from existing products and existing trading methods should be questioned. Developing new products and methods are signs of a healthy company. However what may be thus represented may in truth simply be another desperate ploy to conceal poor trading.

The commonest reason for a big company suffering is that it has lost its way. Over decades the company develops vast management experience in its chosen area and decides that it can conquer the world by moving into other areas. Suddenly it finds that it does not have the management expertise to cope with these new areas. Clark's, the shoe-makers, tried various forms of diversification up to the 1980s. It concluded that it should stick to what it knows best – selling shoes.

The management term for sticking to your knitting is **zero-basing**. Be suspicious of companies which decide they are going into completely new areas to conquer the world.

The lessons from Marconi

Marconi was a cash-rich conglomerate from the well-run GEC whose wide range of electrical products were in every home. Chairman Lord Simpson boasted that he was spending the cash pile carefully accumulated over 30 years as fast as he could. He attempted to move into global telecommunications. Marconi's annual report for 2000 said "The internet boom is a high-tech gold rush, a latter day Klondike of bits and bandwidth. In that earlier gold rush, some prospectors struck it rich. Some went broke. But the people who consistently profited were the ones who supplied the prospectors with the picks, shovels and maps. That is Marconi's starting position."

At first, things went well. Marconi won contracts in the UK, Australia, China, France, Holland and Belgium, in addition to providing internet infrastructure for companies such as Cable & Wireless, UUNET Technologies, Level 3 Communications, MCI/WorldCom and Qwest. The share price rose on Klondike excitement.

In 2001, the dotcom bubble suddenly burst. On 17 May 2001 Marconi issued good results, albeit with qualifications about "scarcity of capital to finance network development" and "slowdown in orders for communications equipment across the whole industry". Later that year, the company wrote down the value of its acquired companies by £3.5 billion, and Simpson went (with a big pay-off).

The share price crashed on 4 July 2001, 48 days later, falling a record 54% in one day, one tenth of all its shares changed hands, and the company was valued at one tenth of its value of ten months earlier.

A Marconi share was worth £8.85 on 16 May 2000, and was expected to double. Three years later that share was worth 0.8p. A subsequent series of share consolidations means that 1 Marconi share in 2004 represents 3,000 shares of 2000. Marconi shares have been worth up to £6 during 2003, but this is the equivalent of 0.2p for a 2000 share. A Marconi investor from 2000 has lost 99.98% of his investment.

What is the company's policy on acquisitions and disposals?

Companies grow in two ways: organically and acquisitively. Organic growth is when a company grows from within by reinvesting some of its profits. Acquisitive growth is when it grows by acquiring new businesses.

Both forms of growth can be healthy, but acquisitive growth is more risky. Marconi was a healthy trading company with a pile of cash. It was brought to the brink of bankruptcy by acquiring businesses at inflated prices which added little to the value of the business.

A healthy policy is to acquire businesses which fit into the existing structure, such as complementing the existing product range and buying out competitors.

All acquisitions carry a price. The old shareholders must be paid off. If the acquiring company does not use cash, it must either borrow money or issue new shares. If it borrows money, it must generate sufficient profit to repay the loan plus earn a similar profit to the existing business. If it issues shares, your holding is diluted. This is only in your interest if the new business is more profitable than the old one.

In other words, acquisitive growth is only in your interests if the acquisition is already *more* profitable than the existing business, or can easily be made so.

What do the Chairman and the Directors say about the future direction of the company?

They will say that the future is rosy. The chairman's or directors' report sometimes say the past year has been bad. ICI chief executive John McAdam described the profit performance as "unsatisfactory", but that was his first year. But the directors report which *predicts* a disastrous year has probably yet to be written.

In January 2002, when Marconi shares had lost 97% of their peak value and were fast sinking into oblivion, chief executive Mike Parton wrote, "the third quarter outcome shows good progress towards our debt and cost reduction targets against the background of a difficult market. It is with regret that we have announced the need for further cost and job reductions, but we are all the more determined not to be dependent on improvement in the market to return the group to profitability."

Your function as an investor is to test the inevitable optimism for credibility. You do this by asking "why?"

If the company has had "a difficult year" in "adverse trading conditions", why will next year be any better?

Directors usually blame bad results on difficult trading conditions, even though there has yet to be a single year which has not been good for some business. It is a rarity, but a report which admits that the company made mistakes probably indicates a better prospect than one which blames trading conditions. A company which admits mistakes will certainly learn from them and seek to prevent further mistakes, which makes it a better investment than one which blames the weather.

The future sales outlook

Is the company's sales growth sustainable?

A company is like a baby; a steady growth is healthy, but rapid growth or no growth is unhealthy. Companies and unit trusts which top the charts one year are often at the bottom next year. Shooting stars quickly look like black holes. Some of the most successful investors have found steady growth companies and simply stuck with them.

A simple example of growth study is Debt Free Direct, a company which specialises in helping people who are seriously in debt. It screens out the irresponsibles in favour of the unfortunates. The company secures 95% of its income from IVAs (Individual Voluntary Agreements) for which it receives a sign-up fee of around £2,700 each plus £75 a month for the lifetime of the IVA, usually five years. Thus the company ended 2003 knowing exactly where £4m future revenue was coming from. Its longer-term future depends on how far the UK consumer remains profligate.

One possible measure is to compare market share with stock share. Stock share is the percentage of the sector’s market capitalisation represented by the company’s market capitalisation. If market share is significantly bigger than stock share, this represents a growing company. For example Northern Rock secured 8.2% of mortgage lending in the year to 2003, though it represents only 4.8% of stock share.

What do the Chairman and Directors say about the past year and the future?

There are certain expressions to look out for in reports:

in accordance with our expectations

This means that the company has performed badly. If it had performed well, the directors would be bragging about it. Instead, a bad performance is excused by saying that they expected it to be bad for some reason, and the management really is competent because it could see this coming. Don’t believe it.

in difficult market conditions

A company which is properly diversified should be able to deal with all market conditions. Alternatively, a company should be able to ensure that seasonal sales are sufficient for the whole year.

cost reductions

The question to ask here is “if a cost can be cut now, why was it not cut sooner?” At best, this is a belated admission that the company has been overspending.

More likely, it is recognition of the desperate situation of the company. The cuts are likely to go beyond fat, and to start cutting into the essential organs of the body. This means reduced sales and reduced capacity for improvement.

In most businesses, particularly service companies, the main cost is staff. So significant cost reductions can only be achieved by losing staff. This means people needing a job, possibly with a grudge, ready to be snapped up by competitors or to band together and form a new competitor with all their inside knowledge.

Prudent control of overheads is an essential element of financial management. However the annual report does not boast about saving £5,000 a year by buying envelopes more cheaply. If cost reductions make it to the annual report, they are having a fire sale.

consolidating our activities

This is the income equivalent to cost reductions. And the question to ask is similar: "If the products are not worth selling now, why were they considered worth selling in the first place?" At best, it means that the company has over-diversified.

Is their view of the past year consistent with the accounts?

Look at the profit and loss account. If it shows a loss, question any ebullient optimism in the chairman's report.

There is an exception, for start-up companies which are still on 'cash burn' (see page 83). There you should look for a reducing loss.

Do they say anything about the current and future competitive environment?

Competition does not kill a healthy business. However competition is wider than just simply other suppliers of the same product.

A food shop is not just competing with other food shops, but with restaurants and suppliers of prepared meals. They compete with internet suppliers, wholesalers and supermarkets.

Do they say anything about external threats?

The absence of any comment about external threats means either that the company does not have any, or that it is too daft to know what they are.

You should form your own view on the external threats, and consider which applies. Some comments on the subject are included in Section 2.10.