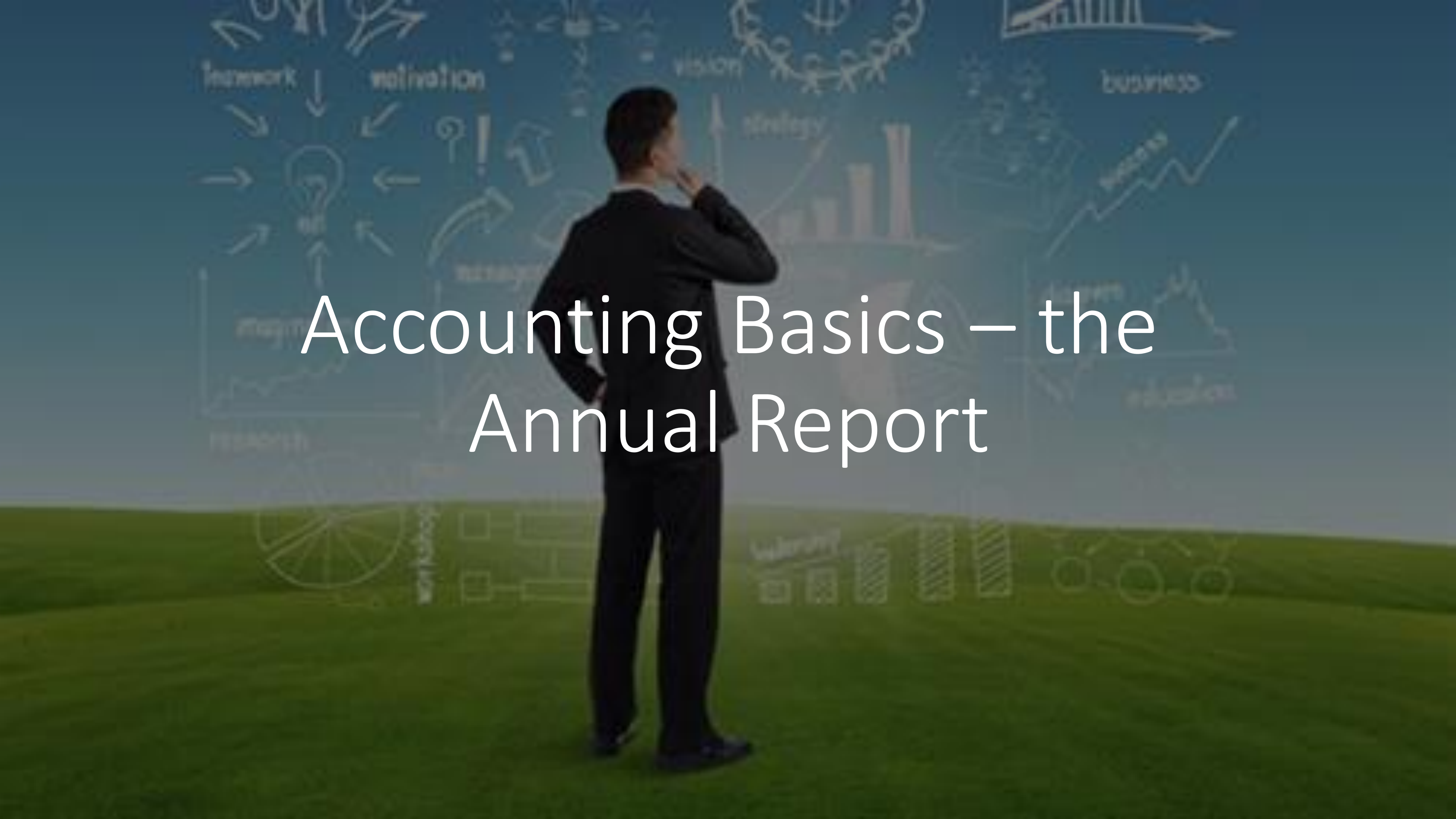

Accounting Basics – the Annual Report

Why is this important?

- Being able to read an annual report is a key skill to being a successful investor. It allows you to understand whether a company is doing well at that moment, whether it has been growing from the previous years (giving you an insight into its future prospects), and whether it is worth investing in.
- In addition to the financial statements, the business analysis section and the Chairman’s report give an insight into the perspectives of qualified experts regarding the industry and the business.
- Finally, the annual report reveals the core business model of a company and a lot of information about the world of business! That’s always useful to know.

Overview

- Every company in the world that is listed on a stock exchange has to publish an **annual report**, which contains 3 key financial statements. Financial statements are quantitative measures of the financial state of a corporation and how well it has done over the past year. The 3 financial statements are as follows:

1. **The income statement** – Measures the profits and losses made over the last year. Is the company making money?
2. **The Balance Sheet** – Measures the assets and the liabilities of the company. What is its value? What are its obligations? Who holds what?
3. **The cash flow statement** – Its what it says on the tin! This report presents the money flowing directly in or out of a business over a year.

- Usually, companies have their own **accountants** that prepare the annual report, which then gets sent to **auditors,** who check the numbers and verify the report.

The Generic Structure of an Annual Report

1. The first item is usually the **chairman's report**, which explores the nature of the industry, the culture and *modus operandi* of the business, and the corporation's various activities from the eyes of the person at the top.

2. This is usually followed by the **management's discussion and analysis** including a deeper financial review of the business operations and the industry, the markets they operate in, and a brief insight into the marketing, R&D, etc. It might delve deeper into some aspects of the Chairman's report.

3. Then we have the **financial statements** outlined in the previous slide. There is no specified order that the 3 statements are written in, but the cash flow (CF) statement is usually last. All of these statements are written in largely the same fashion based on the standardised principles of a regulatory authority. All statements follow the Financial Accounting Standards Board (FASB). For every item, the report gives the number for the previous year and the number for the current year (to show the change). This is the meat of the report!

- **All reports are written according to the Generally Accepted Accunting Principles (GAAP) to standardise them.**

4. The annual report ends with the **notes** section. This is extremely important, as it goes into detail about what each item includes and refers to. It effectively explains the financial statements.

The Income Statement – Gross revenue, COGS, Gross margin,

- **Gross revenue** – first item on income statement. Good indicator of size of firm!
- Total number of goods produced X Price of one good.
- Sometimes, for tech companies like Microsoft, split into product revenue and service revenue (revenue from products like Office 365, video game consoles and revenue from services like cloud computing).
- **Cost of goods sold (COGS)** – These are the direct costs associated with making the product. The variable costs that increase as the output increases. Raw materials used, for example. Might also be split into products and services.
- **At this point, we can find the gross margin:**
- **Gross margin = Gross revenue – COGS.**
- **The gross margin is the first "profit" we look at for a company. We can express it as a percentage by dividing gross margin by gross revenue and multiplying by 100.**
- This is the first part of the Income statement. The pictures on the right are of Microsoft's annual report!

INCOME STATEMENTS

(In millions, except per share amounts)

Year Ended June 30,	2022	2021	2020
Revenue:			
Product	$ 72,732	$ 71,074	$ 68,041
Service and other	125,538	97,014	74,974
Total revenue	198,270	168,088	143,015
Cost of revenue:			
Product	19,064	18,219	16,017
Service and other	43,586	34,013	30,061
Total cost of revenue	62,650	52,232	46,078
Gross margin	135,620	115,856	96,937

Income statement – SG&A, EBITDA, Depreciation, Operating income

- We then remove the **Sales, general and administrative costs (SG&A)** from the gross margin **–** These are the indirect, fixed costs that don't change as output increases. For example, rent (would come under general and administrative). For some tech companies, like Microsoft, the SG&A would also include Research and Development costs.
- Although this isn't on any annual report, EBITDA is a good acronym for understanding where we are now. The value we have is how much a company has **Earned Before** paying **interest** and **taxes**, and before accounting for **depreciation** and **amortization**.
- Let's forget about amortization. What is depreciation? Let's imagine you buy a computer for X dollars. Over a period of time as you use it, the software might start to lag, the battery life might decrease, etc. Therefore, after some time, the computer is worth less than the X dollars you initially paid. **Depreciation is the decrease in value of assets** (like the computer) **over a period of time.**
- We account for this loss in value of the company's assets by treating it as a cost and subtracting it. Depreciation is not written in the annual report, but is accounted for.
- **At this point, we can find operating income:**
- **EBITDA – depreciation = operating income**
- **OR**
- **Gross margin – SG&A – depreciation = operating income**
- **This is our second "profit" for the corporation. Using the previous acronym, EBITDA has now become EBIT (we have considered depreciation).**

Gross margin	**135,620**	115,856	96,937
Research and development	**24,512**	20,716	19,269
Sales and marketing	**21,825**	20,117	19,598
General and administrative	**5,900**	5,107	5,111
Operating income	**83,383**	69,916	52,959

Income Statement – Net income and Retained Earnings

- Now that we have our EBIT, the next steps are simple. First we subtract **interest** (paid on loans to the bank) to get **EBT** (Earnings before Tax). Sometimes called PBT (Profit).
- Then we subtract **income tax** to get **EAT (Earnings After Tax)**. PAT.
- PAT = Net Income!
- This our third "profit" for the company. The report might go on to list Earnings per share and a whole bunch of other items, but net income is what matters.
- From net income, the next item might be **post-dividend income**. This is equal to the **retained earnings** of the company after giving shareholders dividends (a piece of the profits), which is the final item that matters in the income sheet:
- **Retained earnings – How much money is left in the company after paying the suppliers et al. (COGS), the landowners et al. (SG&A), accounting for depreciation, paying the bank (interest), paying the government (tax), and paying the shareholders (dividends).**