Associated Press

ASSOCIATED PRESS NEWSWIRES

Annual Reports Have Quantity, Lack Clarity

June 22, 2004
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Judging from the expanding waistlines of annual reports and rising flood of corporate disclosures, companies seem plenty anxious to convince shareholders that they've got nothing to hide.

Among the 30 major companies in the Dow Jones industrial average, annual reports have grown in thickness at an annual clip of 13 percent over the past five years, reaching a median size of nearly 200 pages this year, according to Credit Suisse First Boston analyst David Zion.

In keeping with the new guidelines published by the Securities and Exchange Commission, some reports display an earnest attempt to improve clarity and context for everyday investors. Companies earning high marks in this arena include International Business Machines Corp. and Wal-Mart Stores Inc.

Often enough, however, the rush to bare the corporate soul can still be more about quantity than clarity – a rambling recitation of numbers, accounting jargon, industry lingo and company spin, with a healthy dose of legalese to ward off litigation.

In the realm of corporate transparency, there's disclosure, and then there's plain English. Consider, for example, these excerpts from recent annual reports.

Goodyear Tire & Rubber Co.: “The Company used an EBITDA multiple representative of the global automotive industry sector to arrive at the fair value of each reporting unit... The EBITDA of the reporting units was adjusted to exclude certain non-recurring or unusual items and corporate charges.”

Alcoa Inc.: “Net income of $938 in 2003 included a charge of $47 representing the cumulative effect of the accounting change for asset retirement obligations upon adoption of Statement of Financial Accounting Standards (SFAS) No. 143.”

Some readers may know that “EBITDA” stands for earnings before interest, taxation, depreciation and amortization. But if they don't, Goodyear doesn't spell it out or explain what an “EBITDA multiple” is.

Similarly, though analysts are attuned to such conventions in financial reports, Alcoa leaves it to the intended audience of common shareholders to figure out that the company earned $938 “million” rather than a mere $938.

As for SFAS No. 143, there's no immediate explanation or flag pointing to a footnote deeper in the report.

Goodyear and Alcoa don't deserve to be singled out. All of this terminology is perfectly legal and still quite common among publicly traded companies, even with the post-scandal push for transparency.

If that's the case, why go to the expense of printing and mailing a glossy, full-color report for common shareholders? After all, a largely identical annual report with no bells is filed publicly with the SEC, available for all to see.

As compared with the substantive information required in the annual “10-K” filing, most annual reports devote considerable energy, paper and ink to public relations. So at the same time that Alcoa is saving space by excluding the word “million” from the required

“Management's Discussion and Analysis,” or “MD&A,” the annual report includes a frilly, 20-page homage to the company's products, accomplishments and vision of the future.

The pitch often begins right away with the traditional letter to shareholders from the chief executive, which usually appears in the opening pages of the report.

In a study of this year's CEO letters from 100 top companies, only 13 passed a basic test of candor by clearly mentioning and discussing the company's bottom-line performance.

“Many companies wrote about corporate governance and their desire to be transparent, and then did not include a discussion of earnings in the letter, which right off the bat does not suggest transparency,” said Laura Rittenhouse, president of andBeyond Communications, an investor relations consulting firm. “A lot of people don't understand accounting, so the letter is an opportunity to reach out to shareholders.”

Meanwhile, it's not even clear that companies are meeting their obligations in terms of the required information.

RateFinancials Inc., an independent research firm, says its study of 120 major companies has shown that about a third “do not accurately represent their true financial condition” in their annual reports and other filings.

While few would argue against increased disclosure, unless some of the new information is presented in everyday language, the main beneficiaries will be investment professionals who can decipher the terminology.

For everyone else, an avalanche of additional words and tables may do little more than make the prospect of reading these documents even more intimidating that it already was.