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HOW TO READ AND UNDERSTAND AN ANNUAL REPORT

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The annual report is a valuable source of information but often the reader has to search for that information. This session will attempt to provide attendees a better understanding of:

- o Content of the annual report
- o Techniques to obtain information from the annual report
- o How to reach conclusions on developing trends for the entity under consideration

MR. F. PIERCE NOBLE: The topic deals with financial statements: how you study and analyze financial statements, how they're prepared, how you use them, how you analyze what's going on with the company. Our main speakers are Harry Dombroski who is the Controller with Hunt Oil. Previously he was with Peat Marwick, so he's dealt with financial statements from both sides of the table -- both the outside auditor and in house working -- with the preparation of the material. He's going to discuss the basic structure of annual reports, the content and so on, and then John Strauss who is Vice President, Secretary and Treasurer with Barrow, Hanley, MeWhinney & Strauss is going to talk about how financial analysts look at the financial statements: What they look at, how they analyze them, what they throw out and ignore, what's meaningful for them, what they look at in terms of trends going from year to year and some of the ratios. And, last, I'll talk about what you might look at in financial statements as a consultant and what would be important to you. I'd like to remind you that this is a session where we want to get a lot of input and questions from the audience. It's going to be fairly informal, so as we're going through our presentations if there are questions, something you'd like to have amplified, or areas that you'd like the speakers to get into, please chime in and participate. With that, Harry, I'll let you get started and talk about the structure of the statements and content.

MR. HARRY M. DOMBROSKI: As Pierce mentioned, what I'm going to try to do is tell you a little bit about the content of an annual report, what you can expect to find in there and what you won't find in there. As I prepared for this, I also started thinking a unique perspective that I could give you is maybe the accountant's role: the accountant's roll in preparing the financial statements included in the annual report and what you can learn from an accounting perspective from the statements and, maybe more importantly,

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what you can't learn. There are significant limitations when you're looking at financial statements that, as accountants, we don't even try to come up with certain figures or certain values, and it's important that you realize what you can't learn as well as what you can learn from looking at financial statements. In order to achieve this goal, I plan to talk a little bit about the objectives and limitations of financial statements, what we try as accountants to project to the users and what limitations we impose on not only ourselves but also the users. I will go through the content, then purpose of each financial statement included in the annual report and try to give you some information you can glean from these statements. Last, I'll just give some recent pronouncements that have been issued by the Financial Accounting Standards Board that may affect your interpretation of statements in the future or on some of the statements right now.

To give you an overview of how accounting and financial statements relate to overall financial reporting, this is a little chart (Chart 1) and basically from the first of the chart to the end of the chart that's all the type of financial information that's available. There are the core financial statements, there are other means of financial reporting like management discussion analysis and letters to shareholders, but there's also other information like discussion of competition, order back-logs and SEC form 10K. There are analyst reports you can reference: economics, statistics, and just present news articles about the company, and you really need all this information to evaluate any annual report. You can't just look at an annual report by itself and learn everything you need to know. When we refer to financial reporting we're primarily talking about the annual report, and as you can see, the financial statements, the notes to financial statements, any supplementary information that might be included with the financials and the management discussion and analysis and the letters to shareholders are what comprise an annual report. In almost every annual report you will find those four pieces to the puzzle. What I'm directly going to reference is the areas covered by the first three: The financial statements, the notes, and the supplementary information. So, with that in mind, I'm going to go ahead and talk about some of the objectives and limitations of the financial statements.

As accountants, our objectives of financial reporting are to provide information that's useful to present to potential investors, creditors, and other users to make a rational investment, credit and similar decisions and to provide information to help investors, creditors and others to assess the amounts, timing and uncertainty of perspective on net cash inflows to the related enterprise. Obviously, that one is important because whether you're a banker and you're lending money to the enterprise or whether you're investing in that enterprise, you want to know what type of cash inflows the company has so it can meet your expectations for cash outflows; the information about the economic resources of an enterprise, which is basically the enterprise's resources and the claims to those resources; and the effects of the transactions, events, and circumstances that change resources and claims to those resources. Now what that basically says is "All we're doing is providing information." The key word in each of those sentences is "information." We don't try to provide any decisions for the users, we just try to provide information. There are those who think we don't even do that very well but that's one of our objectives. But within those objectives there's some significant limitations that you need to be aware of when you're looking at financial statements. One is you're looking at very condensed and simplified information. As you are aware, most corporations have millions of

HOW TO READ AND UNDERSTAND AN ANNUAL REPORT

CHART 1

<------------------- All Information Useful for Investment, Credit, and Similar Decisions --------------->

<---------------------------------- Financial Reporting --------------------------------->

<----- Area Directly Affected by Existing FASB Standards ----->

<------- Basic Financial Statements ------->

Scope of Recognition and Measurement Concepts Statement

Financial Statements	Notes to Financial Statement	Supplementary Information	Other Means of Financial Reporting	Other Information
Statement of Financial Position Statement of Earnings Statement of Cash Flows Statement of Shareholder's Equity	Examples: Accounting Policies Contingencies Inventory Methods Alternative Measures	Examples: Oil and Gas Reserves Information	Examples: Management Discusion and Analysis Letter to Shareholders	Examples: Discussion of Competition and Order Backlog in SEC Form 10-K Analysts' Reports Economic Statistics News Articles About Company

transactions a year. They'll have thousands of accounts they record these in, and you get a two- or three-page summary -- that's all you get. There are some companies that actually round to millions and most companies round to at least thousands, so even if there's an error, there's a perception of precision in accounting. We can fudge a lot when we round to millions. But you are looking at condensed and simplified information. That's important to keep that in mind. There is not a lot of detail.

We use principally historical cost with evaluation of assets and liabilities, and we therefore do not directly measure the value of the enterprise. That is a sore point with many people that we don't disclose what current value a company has. One of the reasons we don't disclose that is, who's going to determine the current value? There are probably a lot of bankers out there who would question the current value of some real estate loans they made. At Hunt Oil, we have dealt with some appraisers in appraising our real estate property, and you get into just practical decisions. Is it the current value of the real estate today in a fire sale? Is it what you could expect to realize over a ten-year period? You have a lot of different variations you can run that would give you a lot of different answers to that question, so as accountants we leave that up to the users. We present the information, and we leave it up to the financial analyst to determine what the current value really is. Also the information is financial in nature and largely reflects financial results of transactions that have already happened. That's an important point to note because in the financial statements you're going to see obviously financial transactions. Operational data are usually found in the management's discussion or operations review, and you need to reference those two to make sense of the financial statements. For example, most oil and gas companies this year should experience an increase in revenue because oil prices went from an average of $14 a barrel in 1988, to around $20 a barrel in 1989, so you know if revenue didn't go up, you've got a problem. But just taking that by itself doesn't answer the question. You don't know whether the price change may have offset any decrease in production or whether the increase in revenue is due to both an increase in production and an increase in price. You only get half that -- half the answer from financial statements, the other half you have to look at the operational data that's included in the annual report. Okay, after talking about letting you know what the objectives and limitations are, I hope you know a little bit about the ground rules now. And I will go through a little bit of the balance sheets, the income statements, and highlight some of the areas we look for.

As most of you know, a balance sheet provides information concerning the entity's assets, liabilities, equity and their relationship to each other at a point in time. It indicates the entity's resources, its assets, and its financial structure, and it does not as I mentioned earlier try to show the value of the business. Total assets do not equal the value of the business, and in most cases the amounts are not even close. But you can use this information in conjunction with the other financial statements to assess an entity's liquidity, financial flexibility and risk. One point I need to make right here is that, when you look at financial statements, all of them are complimentary in nature. You just can't get the answer from the balance sheet. You have to take the balance sheet with the cash-flow statement. You have to take the income statement with the cash-flow statement and the balance sheet to truly make sense of the entity. When we look at a balance sheet, always look at the current ratio. What are the current assets to the current liabilities? This will give you an idea of how well the company's positioned to

meet its current obligations. I'm sure most of you are aware but, when we refer to current assets and current liabilities, we're talking about assets that will either be converted to cash within a year or liabilities that'll be settled by cash within a year. The net working capital is just another way of looking at current assets and current liabilities. We hope the entity's current assets exceed its current liabilities, and it has some flexibility there. Some companies will have a large store of cash, and they'll have a lot of flexibility that they can use in the coming year for acquisitions or whatever. As far as the long-term debt outstanding, obviously with the leveraged buy-outs (LBOs) of the 1980s and probably the 1990s, you need to know what in the end this long-term debt is, not only the long-term portion but also what's the current portion. The capital structure of the company is also apparent from the balance sheet. One of the ratios we look at is the debt-equity ratio. At our company we try to keep that as low as possible. We try to do a lot of internally generative financing as much as possible. If you use the cash-flow statement, you can look at cash flow as a percentage of the investment, and with the income statement you could look at a return on stockholders equity. That's the balance sheet there, and we're going to talk about the statement of earnings a little bit.

Obviously, the statement of earnings shows the current period operations, and it's segregated for a purpose: All financial statements are general purpose in nature, and that is to provide their user with a way to compare one entity to another. Most statements of earnings are segregated by operating earnings, you'll see a section of other income or loss and then earnings before and after income taxes. When looking at statements of earnings, obviously you want to know what net earnings are, what the change was from the last year or the year before that, but a lot of people just look at the bottom line and they stop there. I encourage people not to stop there, but actually to look at the net earnings and to go back up and see what comprises them. What are the earnings from operations? How much is the company earning from its core operations? That'll indicate what the future of the company might be. Are there any significant items that are included in the other income or expense? The whole reason for having income might be an unusual transaction that occurred during the year, and if you would remove that, you could have a loss. So it's important to know what other significant items are in the other income or expense. Are there any cumulatively effective changes in accounting principles? Any discontinued operations or extraordinary items? Obviously those are things you want to be aware of because they may directly impact how you perceive the entity and its performance during that year. I was looking at the Exxon Annual Report before I came over. Exxon actually came up with a new line called the "Income Before Provision for Valdeez," and I haven't seen that one before. I hope we won't see it again. But it's just as important to go back and see what else makes up that net earnings number as to look at the bottom line. Obviously earnings per share if you're investing in the company is a very popular indication of how the company did.

The cash-flow statement is relatively new. The Financial Accounting Standards Board came out with that two or three years ago. It replaced the old "Fund Statement," and most accountants didn't understand the Fund Statement, so I assume most users didn't. This is one of the most useful statements that I'll look at; I can learn a lot about the company by looking at a cash-flow statement. Obviously, it directly or indirectly reflects an entity's cash receipts and cash payments. I say directly or indirectly because there are two methods: One method is called the direct method in which you show actual cash

receipts from sales and payments to vendors. The other method is indirect where you take your net income and reconcile that to your net change in cash. Most companies use the indirect method because it's easier, and there's a requirement, if you do the direct method, you also have to disclose the indirect. So you end up having to do the indirect either way, so most people just do it once. But the important thing you can glean from this is it provides information about the entity's ability to generate cash flow through operations, either repay debt, distribute the dividends, or reinvest or maintain or expand the operating capacity.

In regard to the cash-flow statement, we always look for any significant noncash earnings or losses. You can get this by comparing the income statement with the cash flow. You can see maybe there were some earnings that were noncash in nature, and one of the best examples I can think of is that many companies are adopting FAS 96 which is deferred income taxes or "Accounting for Income Taxes." Most companies will end up taking them out of the income on this because theoretically most of our liabilities are set up at the old 46% rate, and when companies convert to FAS 96, those liabilities will be valued at 34%. So the credit side of that entry runs through earnings. John may have an opinion on this as far as what that does for an entity, but to me it's almost just like a paper transaction. You will see maybe a significant number as cumulatively effective changes in accounting principle per changes in income taxes, but then you'll see that deducted over on your cash-flow statement because that provided no cash at all. That's probably the best example I can think of right now because many companies still have not adopted FAS 96 but will be doing so in the future, and many companies are adopting it this year-end. Obviously when you look at operating cash flow, how much cash flow is the entity generating from operations, you have to generate enough income to either repay your debts or expand your operating capacity. What's the company doing on debt repayments? Is it repaying debt or is it incurring debt? This will give you the cash impact of that. Cash-flow statements are divided into three areas. One is cash flow from operations which is basically what it says it is. A company has cash flow from investing activities, which is cash spent for investments on property, plant and equipment and investments in other companies. Then there's cash flow from financing activities, which is payments or receipt of dividends, proceeds of debt or repayments of debt. But the statement will break down for you what the company's doing with the cash that it's generated, so you can find out what debt repayments are there. If the company has paid dividends or not, we also look at the cash flow as compared to the capital investment. If it's a capital intensive company that may not be a very high percentage, but we like to see what kind of return we're getting on a cash flow -- at my company we look at cash flow from operation as compared to the investment to see what type of return we're getting, and as I mentioned, you can see what kind of property addition they're adding from here.

There are a couple of other statements that I'm not going to get into; one is a statement of stockholders' equity which shows you the changes in stockholders' equity; it will disclose how much in dividends has been paid, other changes in stock, but the most important item to me is the notes to financial statements. I was reading an article the other day, and it referred to the notes as the palace where all the bombs were hiding. As I mentioned, you have summary information in the financial statements, and the notes will give you the details to those transactions. There are a couple reasons you

really need to look at these: One is that they will explain to you to a certain extent what happened within the financial statements, and you will pick up a lot of the information there. I know a lot of people will go through the balance sheet, go through the income statement, cash flow, and then -- nobody wants to read the accounting writing, so users are not going to read the notes, but they are a wealth of information. The second reason is there are a lot of accountants out there who spent a lot of late nights writing these things. And if no one's going to read them, we probably should quit writing them.

Notes will provide you details and transactions summarized in the financial statements, disclosed significant financial events. We have just finished our annual audit and I was going through a Peat Marwick Disclosure Checklist. This list is very thick, so I'm not going to try to hit every disclosure you can possibly have, I'm just going to hit some of the significant ones that I look at. The summary of significant accounting policies tells you the ground rules of what the statements were prepared under. There are two different ways to account for oil and gas operations. One is successful efforts and the other is full cost. If you're trying to compare a full cost company with one using the successful efforts, it is difficult; you have to understand what you're comparing. If it's construction, the company may uses the completed contract method versus percentage of completion. This will tell you the ground rules of what the company's operating under.

In regard to benefit plans, recently the FASB put out FAS 87, "Accounting for Pensions," which has had a material impact on a lot of companies, and there's an exposure draft out on Post-Retirement Medical which will even have more impact. It's an important footnote to look at; you can find out does the company have an unfunded liability or is this company overfunded on its plan? How much pension expense is the company taking into the current period? That's a footnote you can find out a lot from. I was recently talking to our Chief Financial Officer, and he thought this was one of the most important statements that's come out from FASB because he remembers reading a news article about 10 years ago, showing all the companies that had significantly underfunded pension plans, and we read about most of those companies recently having trouble. On the face of the Earnings Statement all you'll see is income taxes. The income tax disclosure will tell you how much is current, i.e., how much we're really paying either the federal government or foreign governments and how much is deferred taxes. Sometimes it helps the user know what an entity is actually incurring as current income taxes. You may want to be aware of any related party transactions. Does the company have investments that it is doing significant transactions with? You find out a lot about the long term-debt: not only do you find out the amount that is outstanding which you can get from the Balance Sheet but also the statement will disclose interest rates. That might be important if all the company's debt is at prime and you have a case of prime going up that's going to affect that company's ability to repay that debt or how much it's going to incur. If it's all at fixed rates, is it high fixed rates incurred a few years ago or is it lower rates? Some companies will even mention some debt covenants in there, covenants that they cannot exceed. It may be that they have to have a current ratio of 125% or more restrictions on dividends. There are companies who will actually mention that in there, and that's important information to know.

Also, and probably more importantly, in long-term debt, you'll see a disclosure of the next five years' current maturities of debt. That'll help you in doing some projections as

far as how much debt is going to become current in the next five years. And it'll have to be paid or refinanced. Inventories are important just because what is the method? Is it LIFO? Is it FIFO? And what were the effects on changes? A good example is refining companies that in the last year had probably written down their inventory generating a noncash operating loss, and they probably wrote them back up with the increase in crude prices. And also all companies disclose contingencies. Are there any losses out there that the company has that you may need to be aware of? Most of the time the company will tell you that the losses are not material but at least the company discloses them.

And finally what I'd like to talk about and I've talked about a few of them already is the recent accounting pronouncements that have come out. We talked about the accounting for pensions (FAS 87), a little known one is the "Consolidation on the Majority Owned Subsidiaries" (FAS 94). That's important because that may effect incomparability in the last couple years. There used to be an exception where you didn't have to consolidate all your majority owned subsidiaries if the activities weren't the same as the primary activities of the company, but this enables a lot of companies to keep debt off the balance sheet. The regulators have rescinded that, and now you have to put all that debt on your balance sheet. It was if you were an oil and gas company that had activities in real estate and you had debt out there, you might be able to account for that as the equity method, and you would disclose the debt in the footnotes, but you didn't have to show it on the balance sheet. Now you have to consolidate that real estate subsidiary. It makes for some funny looking statements, but it does help out if you're looking at the debt of a company. "Accounting for Income Taxes" (FAS 96), is a very complex statement. We spend a lot of time on it, it completely changed the way companies account for taxes. We went from looking at the income statement approach to looking at a balance sheet approach, and I had stated earlier the main impact you may want to be aware of is the fact that you'll have some companies taking in a significant amount of income due to this change and I'll leave it up to you whether you want to consider that or not. One of the biggest items out there right now is an exposure draft on the "Accounting for Post-Retirement Benefits" which basically follows the same methodology as "Accounting for Pensions," but as most of you are probably aware of, companies have not funded that liability. In fact most companies are shocked when they find out what that liability is. And as I used to be in Human Resources for a while, I went to an accounting seminar on How to Account for Post-Retirement Benefits, and the faculty had all these great presentations on how you could whittle down this liability, but nobody talked about the poor guy in Human Resources who's got to go tell all the retirees it is all gone now.

You know it was great for an accounting point you got all these liabilities down, but that's going to become an issue. While it is an issue already, it's going to become even more of an issue in the future. I hope I've given you a little bit of an insight from an accounting perspective.

MR. NOBLE: Why don't we go ahead and take a few questions if they've been stimulated by what Harry has said. I'll throw one out to you Harry that I'd like some help on, and that's a layman's understanding of FAS 96. As I understand, before FAS 96 if you had expenses that were booked for profit and loss purposes, you didn't get a current tax deduction. You would go ahead and tax effect that and end up with I guess a prepaid

tax so not all of that expense would fall through to the bottom line. Whereas FAS 96 somehow is matching timing of when those deductions will take place to determine whether or not you can tax effect it. Is it possible to describe generally for us non-accountants how that might work?

MR. DOMBROSKI: We're still looking for an accountant's language of FAS 96 much less a layman's language. What FAS 96 did, basically, is to require all companies to determine what their tax basis was in all their assets and liabilities and compare that to the GAAP bases of these assets, and they can be different. The best example is property, plant and equipment. For tax purposes, you're allowed to take accelerated depreciation, and for book purposes you're not allowed to do that, so you have a different basis. So, what you have to do is determine what that (tax) basis is. In the case of property, plant and equipment what's going to happen is, if you have a book basis say of $1 million in asset and a tax basis of $500,000, you have a $500,000 "timing difference." You have to schedule out when you think that timing difference is going to reverse and apply future tax rates to it to come up with what your deferred tax liability will be based on. The comparison of that liability with the prior years' liability is you record the difference as for current period deferred taxes. The major impact of FAS 96 has been it used to be we'd get the income statement right. You would take book earnings times a tax rate and that's your taxes and you used to split that out between what's current and what's deferred. The current portion was that amount you paid to the IRS, some of it was deferred that you were going to probably have a liability in the future. Now we don't even care about the income statement. We just value out liability at one year end, and value it at the next and whatever flows through, flows through. The scary part of that is -- is if you make a mistake in one year, the whole thing rolls through the next year. There's no smoothing effect or anything like that. I don't want to bring John in this for you. I have been told by analysts that they even ignore the deferred tax calculation. I know I sit in meetings and start explaining this, and people kind of -- you lose them after about two minutes. John might have some comments on FAS 96.

MR. JOHN L. STRAUSS: I don't on that one in particular. I'd be in the camp of ignoring them.

MR. DOMBROSKI: We work a lot with Standard & Poors. We try to so get our numbers as close as we can, of course, and the people these have told us don't use them that they don't even look at them. It just is something that they don't understand. I'm not sure there is a layman's language.

FROM THE FLOOR: Okay, you've mentioned the FASB exposure draft. What is Hunt Oil doing in response to the exposure draft? Is Hunt Oil setting up a liability?

MR. DOMBROSKI: It's interesting you bring that up. We were just fighting on that when I came over here. Actually we're trying to be fairly aggressive. We have determined our liability, and we've considered making some changes. Really, the major impact of the exposure draft, unfortunately, in my opinion may be that companies are going to change their retirement plans, their benefits, and that probably is going to be the most far-reaching impact. We actually have done that. We've gone through, evaluated the liabilities and said "Whoops," and we went back and we've made plan

changes. We would also like to disclose that number in the financial statements. Our auditors, because the exposure draft is not finalized yet, had some concerns about that, so we're being fairly aggressive. We've determined our liability, and as soon as the exposure draft is a statement, we'll probably book our liability. But we're considering some substantial changes in our retirement plan.

FROM THE FLOOR: Can you elaborate on some of those changes and then also if you plan on funding that?

MR. DOMBROSKI: Well, although I'm not privy to all the changes there have been, I know there had been some considered, and they hadn't been announced yet. I'm not sure of all the changes. As far as funding, I think we're all hoping Congress will help us out and provide a tax deduction, so we can set up a plan similar to the pension plans and be able to make a tax deductible contribution. As most of you may be aware, right now it is very difficult to get a tax deductible contribution proposed for post-retirement medical. It is almost prohibited, and that is why there is such a high liability out there for most companies.

MR. STRAUSS: I have a comment on that, too. It's a good question. The Post-Retirement Health Plan liability from a business point of view may be a great opportunity because as companies fund the plans or are forced to fund them they'll need the money management skills applied. I'm not an expert on that field but that number of the health benefit liability may be larger than the total of retirement benefit liability, that we know today, which is a huge business. It is not good news for companies because it is going to be a very large liability, but there are those of us who can take advantage of it.

I represent, in fact I'm one of the founders, of a firm by the name of Barrow, Hanley, MeWhinney & Strauss. I'm told that the names were listed alphabetically. I would have preferred it the other way.

We're a money management firm. Our group has been together for a long period of time. I've been managing money about 26 or 27 years, and we've got closer to $9 billion in assets despite the fact that the market was down this year. About $7.5 billion of that is in equities.

Looking at annual reports I'm going to be fairly specific in what I present to you. I'm not going to give you a lesson on how to use an annual report, but I am going to tell you how we specifically use it to make stock decisions. For us it's a profitable way of doing business and for our clients a successful way because we've had a very successful record. The firm's been in existence for about 11 years. We rank among the top 5 or 8% of all money managers in terms of performance, and we started with zero 11 years ago. We came out of Republic Bank in Dallas, which doesn't really exist in that form anymore. It is now part of the NCNB group. So we've had a very successful business, and I might parenthetically mention that, when we look at annual reports, probably one of the most important things that people tend not to pay much attention to is the letter to shareholders. It lends creditability to the rest of the annual report, or a lack of creditability in the annual report and I think it's interesting to look historically at the people in management, particularly if they are the same management people to look at what they've said

in prior years so that the comparison of years of annual reports can also be very enlightening. It's interesting to look at things in terms of what the management people have changed, or what they haven't done that they said they would do, or if they've been successful in doing what they've said they've done. I'm going to presume your knowledge of the annual reports, and I'm going to use annual reports in a broad term of including the 10Ks and 10Qs, which are the quarterly reports. The 10Ks are the SEC filings and any other sources of information of which there is some knowledge about the company.

I'm going to presume that we apply a lot of qualitative judgment to the numbers that we see. First off the numbers that you garner from annual reports are easily found in computer services, and so we have an overabundance of information available to us, and analysis of that information is many times not just exactly the way we like it, but we do not suffer from information lack.

Our investment philosophy will give you a framework of what we're trying to do. As investors, hopefully all investors or Investment Managers are trying to take price, which really is the only thing we say that we know about a stock, and apply it to these fundamental characteristics that Harry's been describing in the annual report, and the income statement, etcetera. So price is the thing that is most important to us along with the application of that price to these basic fundamentals. The statement of the FASB is going to produce superior results but will do so while taking below average risk. Some people would think that's contradictory to capital market theory and all the theory we know about analyzing stocks and annual reports, and that is, in order to get higher returns, you're going to have to take high risks. If you are highly disciplined and well thought out in terms of your philosophy and you apply that philosophy in a disciplined approach, you in fact can reduce risk and we believe that we actually get returns, in fact historically not only for the last 11 years but also for the last 18 years that we've had this group together, we've in fact been able to do that. Not every month, not every quarter, sometimes not even every year, but given normal time period of three to five years, you should allow equity performance to work that includes at least one full market cycle. Traditionally three to five years had been a normal economic cycle in which we worked, and we're now in the eighth year of an economic boom, so our time period of five years even is not long enough to catch a full cycle.

Let me go back to what we're looking at in terms of the annual report and in terms of the philosophy we're looking at earnings and the relationship of price to earnings. We're looking for low valuation. We're looking for companies that have prices which are low relative to their basic earnings per share. That's a measure of psychology, and we want to buy companies when they're out of favor. There's a saying in our business "Feed the ducks while they're quacking." We sell the stocks when the public wants them, and we want to buy stocks in the same way as Bernard Brooks said, "Buy your straw hats in the fall." We want to buy things when they're out of season, and so we're really measuring the seasonality of the stock. Mature companies go through cycles in terms of the marketplace, and by the way the marketplace is really a psychological being. If you go along with what's in fashion and what's working, it'll probably have below average results and will not help clients at all. Studies that have been done on the relationship of price to basic underlying earnings of companies have shown that, if you focus on the low end, meaning the low price to earnings relationship, that over long periods of time and I'm

talking about three years or more, you will find that there is a relationship to better performance as that relationship becomes lower and lower. So we believe the price earnings relationship really drives the performance, but taking below average risks in our business is measured by volatility of return. We don't like up 50%, down 40%; up 50% down 40% each year. You can do it that way, but you better have a strong heart and our clients don't. Therefore what you want is consistent long-term positive returns, and you can do that by focusing on risk. Risk for us we control through the relationship of price to underlying book value and the relationship of dividends to price which is another way of saying yield. We focus on higher yield on average, we focus on price/earnings ratios and price to book relationships that are lower than the average company in the marketplace.

This really is part of a marketing presentation that we make. In fact we've been closed as a business in terms of new clients on the equity side for the last four years, so I haven't had to use this and I'm glad I'm able to. We do describe to our clients what we do, and really this gets into how we relate the philosophy and the decision process that we go through, how that's important in our stock decision. Many people analyze companies; some don't analyze them and still try to buy and sell them. But those who do analyze them use the future, either they use the past as a projection of the future or they just look into the future. They look at new products. They look at changes in the company and I don't mean to belittle it because those can be important, but they're willing to pay up, if you will, overpay, we would say, because the product line looks interesting or the record's been very good, and even though our business is not "What did you do for me yesterday?" but "What can you do for me today and tomorrow?" We have to look at the future but we start out with the current fundamentals, and there's where we go back to the balance sheet and look at the quality of these earnings and look at the quality of the numbers that we're looking at, but that becomes a judgment. We relate price to current earnings, current book value and current dividend, and we think it more important to make that step before you go on to making the projections because what we're really trying to do is identify stocks that are cheap and we want it cheap on a no brain kind of decision. This worked on the first part of the price relationship to current fundamentals and can be done on a computer. That is why I point to that in terms of historical data and what we do is kind of different than what has been historically done by analysts. Analysts traditionally have looked at earnings; they try to recreate the earnings statement by taking the current statement and looking at historical statements as well. There is some knowledge to be learned there in terms of what typical ratios and profitability type ratios can be achieved by the company, and they would forecast the number of units that would be growing in this particular industry.

Analysts don't look at the profitability on sales, the profit margins as we call them, and then they would look at other factors, tax rates, changes in tax rates, other investments outside that business. They'd come down with an earnings per share growth rate, and based on the sales growth, they would project out an earnings gross rate and, based on that earnings gross rate, would come up with a price/earnings ratio. And that's a traditional way of analyzing companies. We don't do it that way. We go back to the balance sheet. First off it's one thing to project out earnings over time and it's another to challenge the company's ability to actually generate those earnings. You don't know that until you've gone back to the balance sheet and seen whether the company has a

capability to produce those kinds of earnings. If it doesn't, it's probably because the company is going to have to go out and leverage the balance sheet in order to do it. So the first thing we do is start out with a balance sheet analysis. We start over in the asset side, and we look at the quality of those assets. We take out intangibles, those things that are not really part of the operating assets of the company, because we're really looking and assessing operating management's ability to generate sales and to generate earnings. Then we look over at the liability side and look at return on the equity that's produced and look at the financial part of the management's capability to manage the business. In other words, "What has the company had to do to the balance sheet to leverage it in order to be able to achieve those sales growths?" Did it have to build that new plant and achieve earnings and increase dividends over time?

When we've gotten these assets down to a point where we're contented with the quality of those assets, we're trying to look at the future. In order to do that we look at the profitability on those assets, but not just profitability on the current assets -- we look at the incremental profitability on those assets. In order for companies to be able to grow earnings and grow dividends and be profitable for the investor, they've got to be able to increase both earnings and dividends. Although the accountant tells you the dividends come out of retained earnings or on earnings, we know they really come out of cash. But we look at the profitability on an incremental basis of those assets. If that incremental profitability is improving, then the chances are great that that company is going to be able to increase its future earnings and dividends.

We then take out the liabilities from the assets, and we end up with a figure called "Net Assets of the Company." Many people would like to look at it a little bit differently, but the net assets of the company to us are really the shareholders book value, and this is after debt; it's after special reserves whether they be a deferred tax reserve or whether they be even preferred stock. We're looking at the return on shareholders equity, and the next concept here is "Return on Price." We're taking the balance sheet which is a stated book value and putting it on a market value basis and looking at the return -- the company's ability to earn on that market value of book.

Return on Price really is taking the earnings divided by the book value, that's stated book, and then looking at the relationship and then adjusting that for what we have to pay. We the shareholders have to pay for that book value in the marketplace, and by the way, book value's important because it is a valuation technique. I talked about achieving high returns and low risks. Book value provides a floor for stock. A lot of companies, when the stock gets down to that book value or some multiple of book value that seems low historically, will begin to buy back their stock. It brings in a new kind of investor when the stocks' prices come down and that book value relationship gets larger. We take the return on equity or the earnings for book value and divide by the multiple that we have to pay for that book value. That's the same thing as saying "the return on market value equity." And you come out with a percentage number. Let's discuss some examples. General Foods was considered not a very particularly interesting company particularly back in 1980 because oil was doing so well. Our spot prices were over $40 a barrel and projected to go to $100 according to some bankers because they made loans on that basis.

But General Foods was earning 18% on book value -- stated book value relative to the S&P 500. That's our proxy for the market. It's still an above average attraction in terms of profitability. But the price we had to pay for that book value is less than 1 times, it was less than the market. So on an adjusted basis the return to us, the shareholder, was 20%. You use that same kind of analysis with the S&P and you came out with a 10% return which really wasn't all that attractive in a market where long rates were 14% and 15% in 1980 and short rates, the prime, etcetera were 22%, 23%, 24%. That really wasn't a very attractive return although we're in the stock market trying to do the best job relative to other stocks.

It was selling at roughly book value, and you could see the numbers work out the same.

Merk is a great company earning 45% returns and has all the right drugs, and analysts love it. Yet the price you had to pay for Merk relative to the book value is ten times, so we'll see. I'll have to come back in five years, and you can decide whether this works or doesn't work. I can tell you historically it has.

In regard to the return on price concept, I'm dealing just with information that you know as well as I know. You can do this with your computer, or you can do it with a pencil and an annual report. It doesn't take much sophistication. It is a little sophisticated I think in terms of how we approach the subject of this information. What we do next is make projections. We are in business to project fundamentals and in the business of projecting prices, I should say, on stocks. That's why we buy them in hopes to make money.

We have a couple of models. The dividend discount model which concerns itself with the yield, and the relative term model gets back to those two elements, price to earnings and price to book value. What is very important not only in the relationship of price to earnings price to book value, and price to dividends is also the underlying profitability of the company. This philosophy doesn't produce good results if the profitability of the companies that we're looking at are declining. You can look at companies that have below average profitability -- I'm talking about return on equity -- if that is a declining profitability, you won't do well with the evaluation approach.

I don't think you do well in any approach if you've got a company which is declining in profitability. A good example of that is IBM. IBM over the last several years has been declining in the climb in terms of its profitability despite the size of the company. It used to be 6.5% of the S&P 500. It is now 2% of the S&P, so you can see how much better the S&P's done than IBM. IBM has gone from a 28 or 29% return on equity down to about 13 or 14% on return and now is trying to climb up. I think IBM's attractive today based on the fact that it is going to improve that profitability, it also has a significantly higher yield than the market. It has a significantly lower price to earnings ratio than the market, and the price to book value ratio is about in line with the market. Taking the emotional part of the deal out, and focusing on value allows you to make decisions based on these fundamental characteristics.

FROM THE FLOOR: Besides IBM and Citicorp are any other stocks being recommended?

MR. STRAUSS: If you promise not to go out and buy them. Maybe I could say what other stocks look attractive on that approach. Certainly the Money Center Banks in general do, as highly controversial as they are. Also the tobacco companies, which were the single best group in the 1980s, still look very attractive, and Philip Morris is one. Here's a company that has grown to 20-25% a year, has about a 35% return on equity and sells at less than 10 times earnings, which is considerably less than the markets multiple. Dunn and Bradstreet, is an interesting stock, which has really hurt recently. I believe it was written up about how it was jamming product to its clients and took its stock from about 75 down to 45. If you really believe we're going to a credit crisis in this country and I think we probably are, get the savings and loans and real estate and less developed countries and the impact that has on the financial statements of financial intermediaries in this country, we got a lot of problems. The Dunn & Bradstreet which is a credit analysis agency I think is a very good situation. It has virtually no debt, a very high return on equity in the 25-35% category as well versus the market about 16 or 17%.

FROM THE FLOOR: Okay, now a professional question. How does your method take into account the pension and other post-retirement benefits liability? Are you going to ignore it? Is that just going to be one of the things that you'll consider, or how is that going to work in your analysis?

MR. STRAUSS: It doesn't right now, because we don't know the extent of it. A lot of companies use it. I would say that what we do pay a lot of attention to now in our analysis of companies is the over or underfunding of pension liability. Some companies are in good shape to do that and some are not, in fact the overfunding of a pension fund can be a great asset as we're finding, in the acquisition of companies, either through LBOs or HLTs -- Highly Leveraged Transactions -- right now where companies are being bought and then the buyers take the investments in those assets and either put them into annuities or a guaranteed investment contract, which is really a negative for our business because that money is at risk. The buyer could match assets and liabilities and take all the risk out of it. Then they could take the assets or the overfunded portion of that pension fund and use it somewhere else in the business to extent they're able to do that. I guess my answer is we're ignoring it at this point; we're conscious of it as a potential liability, and we've looked at some of the companies, you know, like General Motors which is also an attractive stock at this point. What that means, I believe General Motors is overfunded. A number of those companies though were underfunded I believe. I think Chrysler might still be in the underfunded position. Certainly the steel industry is probably still in that position, that's a liability. And then if you add on the health benefit liability I think it's a staggering number.

FROM THE FLOOR: One of the main philosophies of the accounting profession or particularly the FASB staff was an attempt to get more comparability between companies and how they determine the pension expense. Was that a concern to you prior to FAS 87, and if it was, has that objective been significantly accomplished?

MR. STRAUSS: It was a concern to some more than others. Again as I mentioned, since the marketplace is such a psychological being there were times when that was important and times when it was not. I have to say there were times when these basic fundamentals get ignored by the marketplace. It's our job to go in and take advantage of

the marketplace where it does ignore these liabilities, if you will, or it made it difficult to analyze some companies in terms of comparability from company to company. But it didn't play as important a part as I might like to think it did, or you might like to think it did. We're somewhat victimized by financial reports -- but I think the investment community certainly was partly responsible for FAS 87 -- in terms of demanding to know what these issues are. Foreign investing has become very popular. I think what people fail to realize is how little they know about many of the balance sheets and income statements of a foreign company, and the technology and the technique of achieving numbers are quite different.

FROM THE FLOOR: I think there are lots of books out on learning how to read about and understand the Annual Statement. Prudential always castigates individual investors who get their annual statement in the mail and just look at the first couple of pages and throw it away. But yet when you go through the books, the company tells you how to read a balance statement. It tells you to calculate all these various ratios. It doesn't seem like you can do anything with those ratios unless you know whether those ratios are higher or lower than they were in the past for that company or whether they're higher meaning more importantly higher than other companies in the same industry. Where does one go to applying that kind of combination?

MR. STRAUSS: It's probably not easy, and it's a good question. It is why analysts exist. That's why research departments exist, and there are fewer than there used to be. There are brokerage firms that produce that information. I can think of Merrill Lynch for example, with its equity screen. Value Line takes the basic fundamentals of all the major companies that report. There are a list of only about 700 or 800 companies that we could even invest in that are big enough, so that's a big universe. There's another service CompuStat Database. It has the software, and it runs all these ratios. You can look at an analysis on a group of companies, look at it on an industry basis, you can look at it on an individual company basis. It's true these ratios by themselves really don't mean a whole lot unless you're able to compare them to the nature of the business that the companies are in. Though a company may be the highest one in that industry, it still may not be a very profitable company whether it is a service company and people are its assets or whether it's plant and equipment that are the compnay's assets. It makes a big difference in terms of how that company is financed and what the balance sheet structure looks like. You can have retailers where some of the numbers still are a lot of off balance sheet financing that doesn't show up when you've got to analyze. It's not an easy question. The information's available. You've got to become an analyst in order to do it, and it's done by individuals. I think companies themselves, when they report their annuals, many times will give you a five- or ten-year history of many of those ratios, which I think is very important. It's important also if it has been a company making acquisitions to go back and to where it's appropriate to adjust those numbers historically or to give historical numbers on those companies acquired so that you could look at the basic nature of the company that's been just added to this existing company.

FROM THE FLOOR: What obligations do companies have when it comes to the balance sheet? You went over some of the annual reports and some of the items that are required. John said some companies will give you five or ten years of history. Are there any rules on that?

MR. STRAUSS: Well, what has to be included in the annual report is, for the balance sheet you have to have two years, and for an income statement you have to have three years. Those are the basic requirements. Some companies are seeing the need for more history and disclosing more information.

FROM THE FLOOR: But as far as other disclosure items, it's really between the auditor and the company.

MR. STRAUSS: There are standards that have been established by the Financial Accounting Standards Board and they're pretty strict. That's one of the services that the auditors provide to make sure there is proper disclosure. But as John said there still are some regulations -- I referenced FASB on consolidation of majority owned subsidiaries -- that do not address a subsidiary or a joint venture that may not be majority element. You still may not have that debt there. There's still a lot of ways to get around that. I don't know if that helped answer your question, but one of the purposes of the auditors is to make sure there is proper disclosure on all types of statements.

MR. DOMBROSKI: I would not forget that annual reports as you see them as a shareholder are public relations tools, and they may be required to have the two years and three years. If they show you a ten year, I'm pretty well assured that it is going to be a good record. The companies that have bad ten year records tend not to publicize them too much. Some companies will include 10Ks with the annual report. It's many times just attached or it's actually part of the annual report. But it's good to know that those things exist. Where you don't have that available and you're looking at companies for one reason, from my point of view it would be for investment, we get the SEC reports where appropriate. Many companies send out 10Ks; many times you can get them from large companies just by asking, rather than having to go to the SEC to get them.

FROM THE FLOOR: What are some of the significant things you might get from a 10K that you wouldn't see in an annual report to assist you in these analyses?

MR. STRAUSS: There's much more detailed accounting and probably Harry could point that out even better than I. Some of the policies and how the companies deal with accounting for acquisitions would be one I could think of. It's just more specific information that they can't have in an annual report.

MR. DOMBROSKI: And if possible like I said it is more accounting oriented, too. If that's possible.

MR. NOBLE: I want to make just a few comments on some areas in the financial statements that might be interesting to us as consultants in working with our clients and knowing what's going on. There's really about four major areas that I think are of interest: the shareholder letter, the income statement, the footnotes to the financial statement and then one area we really haven't talked about yet and that is the Proxy. I will make a few comments on each of these areas. First is the shareholder letter. I want to emphasize that in most companies this is probably the most carefully worded part of the financial statement, it gets a lot of attention from the CEO on down. It's what management uses to let the public know what it wants the public to know. It gives

highlights of the financial statements and what's important, discusses significant happenings that occurred during the year, objectives of the company and where the company is going. It might be useful in not only finding out the condition of the company but also the outlook of the company. Sometimes it may address the outlook of the industry. So it can give you an overview of where the company is, and I'll say where management wants the public to think it's going -- a lot of careful thought goes into that.

I won't spend too much time on the financial part of the statement because we've really heard the experts talk about this, but it's obviously the basic purpose of the annual report. It tells you about the financial health of the company, both from the asset side and the income side. I think it's good to take a look at the trend of revenue and trend of earnings to get an idea whether your client is growing or contracting. Look at the volatility, are these elements that go up and down? Revenue volatility and income volatility can give you a sense of what management might be concerned with about the company. I jokingly say it's also nice to know whether a company can pay its bills. Is it near Chapter 11? How do the current assets in relation to current liabilities look? This might let you know whether you think you're going to get quick payment or a 90-day or 6-month payment. But to understand what's going on within a company can certainly enable you to be better consultants because you will be able to bring issues to the company that will be of interest to it considering its objectives and goals as highlighted here.

The footnotes to the financial statements certainly give a lot of information, and the only one I'm really going to point to is the footnote on retirement plans. It, under FAS 87, gives a fair amount of detail in disclosing the results for both the U.S. and the foreign plans. If you have underfunded plans versus overfunded, you get break downs on those as well. Also, the note gives you a little bit of information on the average assumptions being used. We can get an indication of the financial health of the plans: are they significantly overfunded, underfunded and how has this changed? You merely at this point get disclosure on the other postretirement benefits so that you know whether they exist. You normally get very little financial information out of that, but we all know that will be changing the next couple years. Those footnotes will probably be analyzed more carefully than even the footnotes on the FAS 87.

The other major area is the proxy, and you've got a section in there that gives a lot of information on the company sponsored benefits, whether it is defined benefit, defined contribution, various types of nonqualified plans whether it is an excess benefit plan, a supplemented executive retirement plan (SERP) or employment contracts for a few of the top officers in terms of the kinds of retirement benefits being provided. You have a table of retirement benefits in there for your defined benefit plans. The table can give you a general idea of the level of benefits being provided. You also have a lot of detailed disclosures on other forms of compensation: incentive bonus programs, stock option programs, things that a lot of consultants deal with in companies that really aren't in the regular qualified benefit area. The proxy gives you a lot of input of what's going on. If you're trying to get a better understanding of what a company may do in it's business, there's generally a section in the annual report that gives an overview of the business, the kinds of businesses that the company is in and the nature of those businesses so that you can develop an understanding of what goes on. You also get some

information on the corporate structure of the company, the subsidiaries, find out whether you've got controlled group problems, things that we'll be dealing with in compliance with the Tax Return Act of 1986. We certainly were concerned with that in Section 89, but that's gone by the wayside at least temporarily. Who knows what will be in the next session of congress from that standpoint?

So these are a few areas that I try to take a look at, whether I'm looking at a client or a potential client, to develop a little bit of understanding of the kind of business the company is in, the issues that are of concern to it, the kinds of programs that it has.

FROM THE FLOOR: In terms of business, my company is often in the position where it has gone in on some credit risk with our customers. How would you estimate any guidelines or advice that does or doesn't make sense in that situation?

MR. NOBLE: Would you describe the kind of credit risk you're talking about?

FROM THE FLOOR: Where the insurance company will take on a liability.

MR. NOBLE: Like on a retro-premium arrangement or something like that?

FROM THE FLOOR: Yes, in exchange for a promise to pay us.

MR. NOBLE: It depends on what you perceive the financial solvency of the company is. It very clearly gets to when you look at the statements, how do you project forward and really what may happen in the next year or two with respect to that company as opposed to maybe longer term? I think obviously you have to look at the liquidity of the company, the outlook for earnings, what it did last year, and the comments it makes in relation to that certainly would give you some indication. I don't think it should have been any surprise to astute financial people the companies we see in Chapter 11. Normally you can see bankruptcy coming in advance. When you've got things like retros where you may need to come back to a company next year for more money, things like that I think you can generally see it coming.

MR. STRAUSS: I might mention what I do with an annual report and what Harry does with an annual report may be quite different than what you're requiring. You know I went to business school and I know how to do annual report, I think I do one anyway for cash-flow analysis and credit analysis, but that's different than what I'm doing. It presumes that I've already done that or have that knowledge and go on to something else and I'm not as concerned. I am very concerned about companies staying liquid and being able to reinvest in the future. Whether they have the ability to pay back some of their bills is something that I go beyond in analyzing a company. Usually we're talking about companies such as General Motors or AT&T and those don't become as much of an issue.