WHAT'S AN ANNUAL REPORT?

Purpose
Anatomy of an annual report
Other financial reporting

Purpose

An annual report is exactly what it sounds like — a formal report on a company's performance in the preceding year. A public company produces an annual report for its stockholders, the people and institutions who own the company.

Other interested parties, such as customers and potential investors, read this report, too. In fact, the Securities and Exchange Commission (SEC), a U.S. government agency, requires a public company to keep stockholders informed regularly on the state of its business.

An annual report is one of the most important documents a company produces and is often the first document someone consults when researching a company. It reports how the company did financially and often explains the scope of its business mission and management philosophy.

For these reasons (and because the SEC requires publication of much of the information in the annual report), companies take the development of an annual report seriously. They carefully consider its design and construction and even the paper to print it on. Today, many companies also produce Web and CD-ROM versions of their annual reports.

Anatomy of an annual report

While most annual reports contain optional elements, all reports contain information the SEC requires.

Optional elements include:

- Financial highlights
- Letter to stockholders
- Corporate message
- Board of directors and management
- Stockholder information

SEC-required elements include:

- Report of management
- Auditors' report
- Management discussion
- Financial statements and notes
- Selected financial data

Financial highlights. Probably the most often-read

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section of any annual report, these highlights give a quick summary of a company's performance. The figures appear in a short table, usually accompanied by supporting graphs.

Letter to stockholders. This letter may be from the chairperson of the board of directors, the chief executive officer, or both. It can provide an analysis and a play-by-play review of the year's events, including any problems, issues, and successes the company had. It usually reflects the business philosophy and management style of the company's executives, and often it lays out the company's direction for the next year.

Corporate message. Some analysts, business executives, and stockholders consider this message an advertisement for the company; others find it more useful. However, it almost always reflects how a company sees itself, or how it would like others to see it. Here, the company can explain itself to stockholders, using photographs, illustrations, and text. This message may cover the company's lines of business, markets, mission, management philosophy, corporate culture, and strategic direction.

Board of directors and management. This list gives the names and position titles of the company's board of directors and top management team. Sometimes companies include photographs.

Stockholder information. This information covers the basics — the company's corporate office headquarters, the exchanges on which the company trades its stock, the location and time of the next annual stockholder's meeting, and other general stockholder service information. Stockholder information is usually in the back of the annual report.

Report of management. This letter, usually from the board chairperson and the chief financial officer, takes responsibility for the validity of the financial information in the annual report, and states that the report complies with SEC and other legal requirements. The discussion attests to the presence of internal accounting control systems that cover effectiveness of operations, reliability of financial reporting, and compliance with federal laws.

Auditors' report. This summary of the findings of an independent firm of certified public accountants shows whether the financial statements are complete, reasonable, and prepared consistent with generally accepted accounting principles (GAAP) at a set time.

Management discussion. This series of short, detailed reports discusses and analyzes the company's performance. It covers results of operations, and the adequacy of liquid and capital resources to fund operations.

Financial statements and notes. These statements provide the raw numbers for the company's financial

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performance and recent financial history. The SEC requires three statements — statement of earnings, statement of financial position, and statement of cash flows — all covered in this Guide. (The statement of stockholders' equity is not addressed here.) These statements include a comprehensive set of related notes that provide explanations, additional detail, and supplementary financial information.

Selected financial data. This information summarizes a company's financial condition and performance over five years or longer. Data for making comparisons over time may include revenue (sales), gross profit, net earnings (net income), earnings per share, dividends per share, financial ratios such as return on equity, number of shares outstanding, and the market price per share.

Other financial reporting

The financial statements and related notes in the annual report are primary sources of financial information available to investors, financial analysts, and the public.

To learn about audited financial information, see What's the auditors' report?

Other primary financial information sources include SEC Form 10-K, which the SEC requires companies to submit yearly. This audited form contains more detailed information than the financial statements in the annual report. Companies also provide interim financial reports to stockholders and file an unaudited SEC Form 10-Q quarterly. These quarterly reports provide briefer, more aggregated data for the quarter and year to date.

Companies provide summary financial information throughout the annual report and through news conferences and press releases. To obtain more financial information on companies, visit Resources. Here, you'll find Internet links and print and other resources to help you extend your investment-related education.

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Regardless of who the preparers are, federal securities laws require publicly-owned companies to follow a set of rules and financial reporting guidelines. Associations — such as the Financial Accounting Standards Board (FASB), a private organization of accounting professionals, and the Securities and Exchange Commission (SEC), a U.S. government agency — develop the rules and guidelines. These generally accepted accounting principles (GAAP) help ensure that the financial information reported is reliable and consistent in form with the reports all other companies prepare. GAAP also helps safeguard against investor fraud.

Although all companies follow common standards and requirements, they report on their financial performance in varied ways. Many decisions — from the statements' names to the accounts within them and the ways management calculates the numbers — are left to companies' discretion.

What's the auditors' report?

The SEC requires publicly owned companies to submit audited financial statements each year.

The auditors' report is a summary of the results of an audit, or examination, of the financial statements by an independent firm of certified public accountants. The audit is an attempt to determine whether a company's financial statements report the company's financial status accurately and reliably.

During an audit, for example, the auditors investigate a company's internal accounting controls, confirm the existence of many assets, and gather supporting information from external sources. The auditors make sure the financial statements are complete, reasonable, and prepared consistent with GAAP at a set time. If the auditors consider the statements are fair presentations of the company's financial position in relation to GAAP, they issue an "unqualified" opinion.

The notes

The notes are an integral part of the financial statements. They tell you how the company arrived at the numbers in the statements.

The notes are required reading to understand the financial statements. Companies use notes to explain how they arrived at the numbers in the financial statements and to describe any significant events or changes in procedures that may affect the numbers. Notes also explain items in the statements and report details of the company's financial performance not shown in the statements.

A note might explain, for example, that a company's accounting methods have changed from the previous year or differ significantly from methods other companies in the same industry use (assuming they follow GAAP). Analysts might examine why the

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company changed accounting methods, probing, for example, to learn whether the change distorts the company's financial results.

Another note might disclose an acquisition that may have a material effect on the company's financial condition, both short term and long term. For example, with its acquisition of Lotus in 1995, IBM incurred costs and assumed liabilities associated with this significant event.

Finally, a note might provide additional detail on an item in a financial statement. For example, a note on "Investments and sundry assets" on the statement of financial position lists the assets IBM includes in this category. (One listing is the intangible asset called goodwill.)

STATEMENT OF EARNINGS

(income statement, earnings report, statement of profit and loss)

Purpose
Key numbers
Using the information

IBM 1996 statement of earnings

Purpose

The statement of earnings shows how much revenue a company brings into the business by providing goods or services, or both, to its customers for a set time (usually one year). It also shows the costs and expenses associated with earning that revenue during that time.

In an annual report, the statement of earnings shows sales revenue and expenses for at least the last three years. The net earnings (or loss), often literally the "bottom line" on the statement, shows how much the company earned (or lost).

Key numbers

The statement of earnings shows two main categories of information for each year covered:

- the revenue from products and services sold
- the expenses, or costs, of doing business

To interpret this information, analysts look at several key numbers:

- revenue
- gross profit
- operating income (operating profit)
- net earnings (net income, net profit)
- earnings per share

Key number: Revenue

For most companies, revenue represents the sales made during a certain period, even if the money has not yet

Companies earn revenue in one or more of the following ways:

- by selling products or services, or both

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come into the company.

- by leasing and renting equipment or property to others
- by receiving interest from loans to other companies or individuals

Some companies have only one source of revenue; others have several. For example, IBM reports revenue from its products, such as computer hardware and software. It also reports revenue from its services, which include maintenance, rentals, and financing.

Key number: Gross profit

A rule of business is, "It takes money to make money." Typically, producing goods for sale is the greatest cost of generating revenue. For example, a computer manufacturing company must buy wiring and other raw materials to make computers; pay wages to workers and managers; and spend money on overhead — power, facilities, and maintenance.

A company deducts these costs (cost of sales, cost of goods sold) from revenue, showing gross profit (or loss).

Key number: Operating income

In addition to the expenses directly related to producing goods and services, companies incur operating expenses. These include advertising, salaries, rent, research and development, office supplies, and any other administrative amounts spent.

A company deducts these operating expenses from gross profit, resulting in operating income (or loss).

Operating income represents a company's revenue minus all expenses required to obtain that revenue. From this key number, companies deduct costs relating to debt financing and tax expenses. The remainder is called net earnings.

Key number: Net earnings

Net earnings are the "bottom line" (often literally the last line on the statement). After a company deducts all costs and expenses from revenue, the statement of earnings shows the net earnings (or loss). When revenue exceeds costs and expenses, the bottom line shows a profit. When costs and expenses exceed revenue, the bottom line shows a loss.

Growth in net earnings usually signals that a company is doing well.

Key number: Earnings per share

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Earnings per share (EPS) shows how much money stockholders would receive for each share of stock if the company distributed all net earnings to its stockholders. For example, if the net earnings are $1 million and 500,000 shares are outstanding, the earnings per share are $2 ($1 million ÷ 500,000 shares = $2).

Although all net earnings really belong to the stockholders, a company almost never distributes the full amount to them directly. A company needs money to grow, so it takes part of the net earnings and reinvests that money in itself. The total amount of a company's net earnings since its inception, minus any payments made to stockholders, is called retained earnings.

Although the term may suggest a large pool of cash, that image is misleading. Retained earnings is actually part of stockholders' equity and represents the portion of a company's assets that is financed from profitable operations rather than from selling stock to investors or borrowing from external sources. If the company reinvests those earnings profitably, the stockholders benefit from that reinvestment over the long term.

A second way stockholders benefit from retained earnings is through dividends. A company's board of directors, with the advice of management, decides on the amount of dividends per share to pay. Companies usually pay dividends quarterly; however, many companies don't pay dividends at all, and a few pay dividends irregularly.

Using the information

Now that you've reviewed a brief introduction to the statement of earnings, you can learn about ways to interpret this information.

- To see how analysts use this statement and related information, read Analyzing the statements.
- To get tips from three experienced investors on using this statement, visit a business school dean, a business executive, and a high school economics teacher.

STATEMENT OF FINANCIAL POSITION

(balance sheet)

Purpose
Key numbers
Using the information

Purpose

The statement of financial position reports a company's financial status at a set date noted on the statement. The statement is like a snapshot because it shows what the company is worth at that set date. The statement shows:

- what the company owns
- what the company owes

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IBM 1996 statement of financial position

- what belongs to the owners

Analysts often call the statement of financial position a balance sheet because of the way one part — assets — is in balance with the sum of the other two parts — liabilities and stockholders' equity.

In an annual report, the statement of financial position includes information for at least the last two years to allow comparison of changes between years.

Key numbers

The statement of financial position shows three main categories of information for each year covered. To interpret this information, analysts look at three key numbers related to these categories:

- assets (what the company owns)
- liabilities (what the company owes)
- stockholders' equity (what belongs to the owners)

Key number: Assets

Companies own things, called assets. These things might be physical assets such as buildings, trucks, inventories of products, equipment, and cash. Or things might be intangible assets such as goodwill, trademarks, and patents.

Assets are either current or noncurrent. Current assets are things a company expects to convert to cash within one year. Examples are accounts receivable or inventories of products to sell. Finally, current assets include cash and securities such as treasury bills and certificates of deposit the company expects to convert to cash within the year.

Noncurrent assets are things a company does not intend to convert to cash or that would take longer than a year to convert. Noncurrent assets include fixed assets, often listed as "Property, plant, and equipment" because that's what they usually are. Companies use fixed assets to manufacture, display, store, and transport products.

The amounts of fixed assets vary by company and industry. For example, manufacturing companies generally have a large investment in fixed assets because making things requires property, plant, and equipment. Service companies usually have fewer fixed assets.

Key number: Liabilities

On the statement of financial position, debts are called liabilities. All companies have liabilities. Examples

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of liabilities include:

- money owed to banks and other lenders
- money owed to suppliers of goods and services (accounts payable)
- taxes owed to government authorities
- rents owed to owners of land and buildings

Liabilities are either current (short term) or long term. Current liabilities are due within one year. Long-term liabilities are due after one year.

Although liabilities are a necessary part of doing business, companies must manage their liabilities carefully. If a company cannot make interest payments on time and repay the principal when due, the company can be forced to declare bankruptcy and either reorganize or disband.

Key number: Stockholders' equity

Stockholders' equity is the amount owners invested in new stock plus the earnings the company retained since it started. (Retained earnings is the amount of profit kept after dividends are paid.) On the statement of financial position the amount of stockholders' equity always equals the value of all the assets minus all the liabilities. For example, if a company's assets are valued at $10,000 and liabilities total $6,000, the equity is $4,000.

Using the information

Now that you've reviewed a brief introduction to the statement of financial position, you can learn about ways to interpret this information.

- To see how analysts use this statement and related information, read Analyzing the statements.
- To get tips from an experienced investor on using this statement, visit a business school dean.

STATEMENT OF CASH FLOWS

Purpose
Key numbers
Using the information

IBM 1996 statement of cash flows

Purpose

The statement of cash flows reports the flow of cash into and out of a company in a given year.

Cash is a company's lifeblood. Cash includes currency, checks on hand, and deposits in banks. Cash equivalents are short-term, temporary investments — such as treasury bills, certificates of deposit, or commercial paper — that can be quickly and easily converted to cash.

A company uses cash to pay bills, repay loans, and

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make investments, allowing it to provide goods and services to customers. If all goes well, a company uses cash to generate even more cash as a result of higher profits.

Key numbers

The statement of cash flows reports the company's sources and uses of cash and the beginning and ending values for cash and cash equivalents each year. It also includes (near the bottom of the statement) the combined total change in cash and cash equivalents from all sources and uses of cash.

Key numbers in this statement show results of transactions in three categories that are sources and uses of cash:

- net cash provided (or used) by operating activities
- net cash provided (or used) by investing activities
- net cash provided (or used) by financing activities

Key number: Net cash provided (or used) by operating activities

A company generates cash just from operating its business. Therefore, the first key number is net cash provided from operating activities. This total includes some items from the statement of earnings; for example:

- net earnings, showing the company's profit (or loss)
- depreciation expense

This key number also includes changes in some items from the statement of financial position:

- Inventory changes. (Increases in inventories use cash and reductions provide cash.)
- Changes in accounts receivable, the sales the company has not yet been paid for. (Again, increases use cash and decreases provide cash.)
- Changes in accounts payable, the cash a company owes its vendors and suppliers. (In this area, increases provide cash and decreases use cash.)

The statement of cash flows adds the net cash from each type of operating activity and reports the company's total net cash provided (or used) by all operating activities.

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collect accounts receivable the less valuable they are.

Analysis: statement of cash flows

Analysts use the statement of cash flows to determine how effectively a company generates and manages cash. Analysts look most closely at the cash from operating activities in evaluating a company's potential for long-term success because this figure shows how efficiently the company can produce and sell its primary product or service.

Analysts also evaluate cash flows in relation to earnings figures (from the statement of earnings). For example, in some cases, a company can report positive earnings on the statement of earnings and still report a negative net cash flow on the statement of cash flows. This situation may occur when a company is unable to meet the current demand for its products and consequently invests its profits, or even borrows additional money, to expand its manufacturing capability (for example, by purchasing equipment or new facilities). When such a situation occurs, analysts look for the implications. They try to determine if the prospective demand for the company's product is great enough to justify the expenditures and new debt.

Looking at other information

Most analysts agree that the financial statements, financial ratios, and other comparative measures offer the best starting points for evaluating a company. However, they look at these items to provide only a portion of the information required to adequately evaluate a company for investment.

Analysts begin to put the key numbers into a larger context by looking at two other critical parts of the annual report itself:

For more information on the notes to the financial statements, see The notes.

- The notes to the financial statements offer further explanation of the numbers on the statements. For example, for the statement of earnings, notes might describe changes in a company's investment in research and development (R&D). For the statement of financial position, notes might describe significant liabilities and contingencies.

For information on the components of an annual report, see What's an annual report?

- The management discussion section provides management's perspective on the company's financial operation and performance. Reading this section in consecutive annual reports also allows analysts to gather more subjective information about a company, such as its ability to articulate and consistently pursue long-term goals.

For company financial information not contained in the annual report, such as that in copies of Form 10-K or Form 10-Q filed with the Securities and Exchange Commission, analysts and investors frequently contact

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the company's investor relations department for copies of those forms.

Finally, analysts extend the scope of their financial information comparisons beyond the two- to three-year figures in a single set of financial statements. Instead, they look at the same ratios and performance measures over five- to ten-year periods. To see changes in IBM's financial record over time, visit the Historical Charts.

Analysts also compare these figures with several other numbers from other sources of business and economic information. For example, they:

- Compare many growth figures, such as growth in sales, with the rate of inflation, and look for rates that exceed that of inflation.
- Look at figures for competing companies to determine a company's strength in its industry.
- Examine industry averages to gain a historical perspective in order to evaluate a company's chances for long-term success.

For additional information on the ways analysts interpret financial information, refer to accounting and finance textbooks and to some of the sources listed in Resources.

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