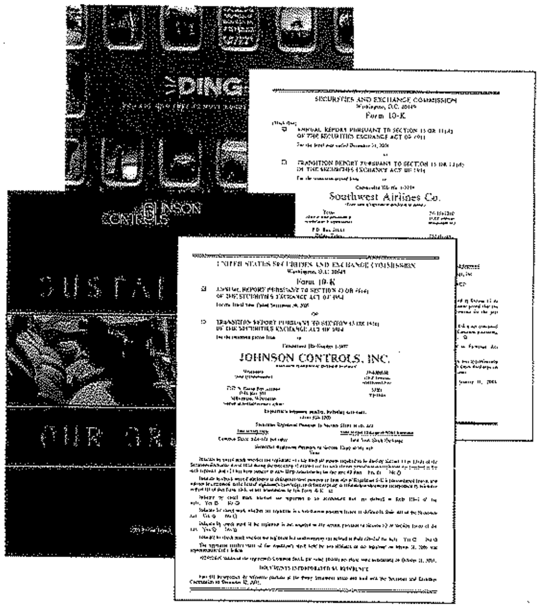
The (Somewhat) Straight Story

Information Found in Annual Reports

Objective A

The Yearly Roundup

Each year, publicly-held companies are obligated by law to "tell their story." Since 1934, the Securities and Exchange Commission (SEC) has required these companies to provide shareholders certain financial reports in standardized forms. Most investors are familiar with the granddaddy of these reports: Form 10-K, also known as the annual report.



Because the 10-K is so detailed (and full of words and numbers that are familiar mostly to lawyers and chief financial officers), many companies also produce a more user-friendly annual report. This version, unlike Form 10-K, often contains photographs and a narrative that sometimes reads like a promotional piece.

One of the annual report's main purposes is to outline a business's financial status. The report also explains the company's business activities for the previous twelve-month **fiscal year**.

When Is It Released?

You probably know what it's like to have a deadline for a report. Publicly-held companies have deadlines for their annual reports, as well. Traditionally, the SEC has required Form 10-K to be filed within 90 days of the company's fiscal year end. But, the SEC is now phasing in an accelerated system that would get financial data to shareholders more quickly. Companies with a market capitalization (market cap) below $75 million will stay on the 90-day schedule. Those with a market cap between $75 million and $700 million have to report within 75 days. Beginning in 2007, large companies with a market cap over $700 million will have to file their annual reports within 60 days of the end of their fiscal year.

Form 10-K is posted on the EDGAR portion of the SEC web site (www.sec.gov). Most companies post their annual reports on their web sites, as well. Printed copies go out to investors in the mail, sometime before the company's annual meeting.

Who Are the Players?

Before delving into the components of an annual report, you need to know a bit about the basic structure of a corporation. As you flip through the pages of many annual reports, you'll see photographs of the company's major players. It's a good idea to know what these people are responsible for, what their job titles are, and what their signatures at the end of certain pages mean.

Most large corporations have a two-level management structure. The **board of directors** makes up one level. Every public company must have a board of directors. The length of the directors' terms varies from company to company, as does the number of people who sit on the board.

Stockholders elect the board members. In turn, directors are responsible for making decisions that are in the stockholders' best interest. For example, the board determines a company's dividend policy. Board members also serve on important committees, such as the audit and compensation committees. The audit committee is responsible for making sure the company's

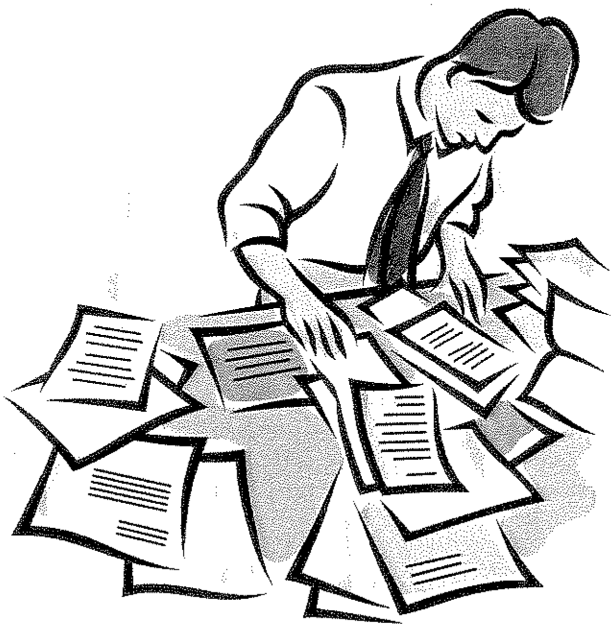
Objectives:

A. **Explain the purpose of an annual report.**

B. **Describe the components of an annual report.**

Objective A

financial statements are accurate. To do so, they select outside accountants to audit (or independently examine) the statements. These accountants are considered to be "outside" because they have no financial interest in the company.



The compensation committee sets the base salary for the company's top executives. This committee also oversees other compensation, such as stock options and bonuses. In recent years, some boards have been questioned about allowing extremely high compensation packages that didn't seem justifiable based on the company's earnings.

There are two kinds of directors: inside and outside. Inside directors are employees of the company or major stockholders. Outside directors, who are usually chosen for their business abilities, are not associated with the company and are said to be "independent." At least 50 percent of a board must be made up of such independent directors. Why is this important? Remember, directors are expected to act in the stockholders' best interest. Independent directors can help keep the company's management in check. Having non-executives on the board, and all of the other board members' responsibilities, make up a system known as **corporate governance**—a term used to describe the ways directors control the corporation.

The other level in a corporate structure is the top management team, sometimes called **corporate officers.** They are responsible for the day-to-day operations and for making sure the company is profitable. The top manager is usually called the chief executive officer (CEO). He or she may also be designated as the president of the company. In many companies, the CEO is also the chairman of the board of directors. Some companies may also have a chief operations officer (COO), sometimes also designated as a senior or executive vice president.

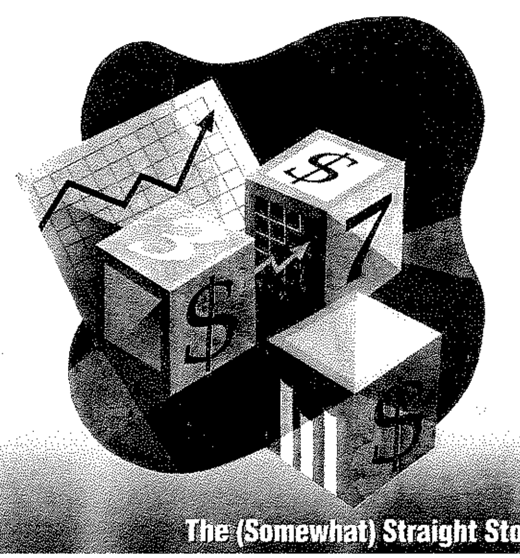
As an investor, pay attention to a key member of the management team: the chief financial officer (CFO). He or she is responsible for reporting the company's financial performance to the board of directors, and ultimately to the shareholders and to the SEC.

Why Is It Important?

Developing an annual report, whether it's the 10-K or the attractive version, is a tremendous undertaking. Companies spend a great deal of time and money to produce them. These reports are important, not only because the SEC requires them, but because many investors use the annual report as the main source of information about a company. An investor's decision on whether or not to invest in a company can hinge on the information provided in the report. With careful reading, you can discover whether a company is growing, or if it's heading in the wrong direction.

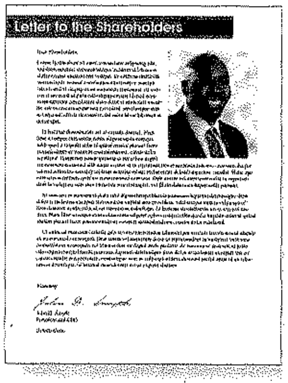
Objective B

What's In It?



While every company's 10-K follows the same format, the look and length of annual reports do vary from company to company. Some are practically as long as books, with beautiful covers and lots of glossy photographs. Others are much less flashy. Many investors, it seems, just want to see "the numbers." In fact, many large companies are adopting a new trend—they are sending their shareholders what is called the "10K-Wrap," which is simply the 10-K wrapped in a cover with a little extra narrative. Other companies, such as Microsoft and Berkshire Hathaway, produce simple black-and-white annual reports without a single photograph in sight.

The section titles in an annual report will vary from company to company. The order in which they appear will be different as well. For most annual reports, however, you will find the following basic format:


Letter to the Shareholders

- **Letter to the Shareholders**
  Up front and center of most annual reports is the Letter to the Shareholders, written by the CEO and/or president of the company. Most of these letters paint an optimistic picture of the company's performance for the year. A common criticism of this section of the report is that it is often filled with vague wording and jargon; and therefore, it may or may not be an accurate, or straight, story of the year's operations.

- **Annual Highlights**
  This section isn't always labeled, but you'll know it when you see it. The pages usually look like a marketing brochure. Typically, there are lots of photographs that showcase the goods and services that the company offers. From this section, you should be able to get a good idea of what the company does, or at least what it is most proud of. Also, you may learn about those business activities that management believes make up the year's highlights. If a company launched a new product, this is where you'd read about it. If there's something they're especially happy about—making inroads into a new market, for example—expect to find out about it here.

- **Financial Highlights**
  The financial highlights, sometimes called the financial summary, usually come next. This section, often just a page in length, is required by the SEC. Here, management provides graphs, charts, and/or tables that compare finances for the past two to five years. This is a quick look at such things as revenue, net income, earnings per share, and total assets.

- **Management's Discussion and Analysis (MD&A)**
  Next up is the Management's Discussion and Analysis of Financial Condition and Results of Operations. (Whew!) The "warm-up" to the financial statements, the MD&A section is also required by the SEC. Management, not the public relations department, must discuss three areas: a) results of operations, b) capital resources, and c) liquidity. In other words, they have to talk about:
  - the money they made and the money they spent,
  - all the resources they use repeatedly, such as machinery, buildings, and equipment, and
  - how much cash they have, or assets that could easily be converted into cash.

  They also have to talk about past and future conditions that could "materially" (significantly) affect their business.

The section usually begins with an executive summary that explains what kind of business they're in. Following that is a lengthy discussion of what is going on in the business. Let's say you are reading an annual report of a company that produces textbooks. If the company didn't sell as many textbooks this year as it did last year, the MD&A section would have an explanation of what happened in the market to cause this. For example, maybe the company did business in some states where the education budgets had been cut, so they could not afford to buy as many books as they could the year before. Since this is an "industry-related" variable, the company would explain it in the MD&A.

You might also get a look into the nuts and bolts of how the company works to streamline its operations. In Home Depot's MD&A for 2004, for example, management discussed how implementing cordless scan guns and self-checkout registers in 1,000 stores meant that employees were more available to spend time on customer service.

The Oracle of Omaha

No discussion of shareholder letters can go too far without mentioning Warren Buffett, also known as the "Oracle of Omaha." Buffett is considered to be the most successful investor and business success story in modern history. Shares in his company, Berkshire Hathaway, go for upwards of $90,000—*for a single share*. The letters that he writes to his shareholders have been called "legendary." What makes them different? For one thing, Buffett is a master of plain English. His letters are highly readable and even entertaining. Also, he is surprisingly candid. If he believes that he's made mistakes during the year, he admits to them.

Much can be learned from the way Warren Buffett sees the stock market, and he has shared this wisdom with the public through his letters. The letters, dating back to 1977, can be found at http://www.berkshirehathaway.com/letters/letters.html.

- **Financial Statements**
While the pages containing the financial statements are not as attractive as the rest of the report, they make up the most important section. Many investment advisors tell you to skip the pictures and go right to the financial statements to get the straight story on the company's year. The SEC requires companies to follow a reporting system called GAAP, which stands for "generally accepted accounting principles." These principles have been established by the Financial Accounting Standards Board (FASB). FASB has determined that such principles should ultimately help investors and potential investors make investment decisions and help creditors to make credit decisions. GAAP also provides a "common language" for everyone—analysts, investors, or creditors—to use as they study financial statements.

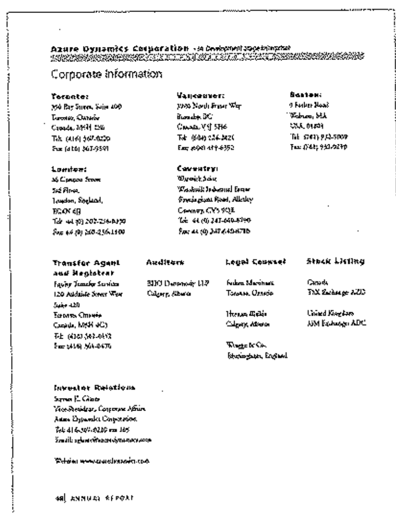
At the very least, anyone who is reviewing a company's statements typically wants information about profits, assets (what the company *owns*), and liabilities (what the company *owes*.) As you may already know, information about assets and liabilities is found primarily in the **balance sheet**. Information about profits is found in the **income statement**. Information about cash the company received, and how that cash was used, is found in the **cash flow statement**.

- **Notes to the Financial Statements**
Management discusses those things that could materially affect their business in the MD&A. The section called "Notes to the Financial Statements" is another place for them to describe such things. Many times, plain numbers cannot adequately express conditions that have a financial impact on a company's fiscal year. The notes provide a place to deliver the straight story. In fact, the notes can be just as important and informative as the statements themselves. This is a section of the annual report that should not be skipped.

- **Report of Management on the Financial Statements**
This section comes from, and is signed by, the CEO and the CFO of the company. Here, these company officers state that they are responsible for the integrity and objectivity of the financial statements. They also describe the internal controls that are in place within the company to ensure that the numbers are as accurate as possible.

- **Report of Independent Auditor**
After management has stated that they can vouch for the financial statements, independent auditors have their say. They study the financial statements and determine if they have been prepared accurately in relation to GAAP. Auditors can provide a few types of opinions, including unqualified, qualified, and adverse. Unqualified, which is the best opinion rendered, means that the financial statements have been presented fairly. Qualified means the auditors have concluded that at least part of the statements have not been presented fairly. This could be a sign of trouble for the company. Adverse means that the auditors find the statements, as a whole, to be *not* in accordance with GAAP. An adverse opinion is definitely a sign of trouble.

- **"Back Cover" Information**
Finally, most annual reports wrap up by including important information for shareholders on the last page or back cover. Here you will find the names and titles of the top management officers, as well as the names of the board of directors and the committees on which they serve. You also find the address of the company's headquarters and the date and time of the next annual meeting.


Azure Dynamics Corporation
Corporate Information
Toronto:
Vancouver:
Boston:
London:
Coventry:
Transfer Agent and Registrar
Auditors
Legal Counsel
Stock Listing
Investor Relations
ANNUAL REPORT

The Business of Annual Reports

Millions of dollars are spent each year in the production of annual reports. Independent audits can cost a company hundreds of thousands of dollars. Firms who specialize in corporate communications can charge hefty fees to help a company develop the report's message and theme. Graphic artists are hired to design the look and feel of the report. Some annual reports are so attractive, they actually win design awards.