CHAPTER 2 - ANNUAL REPORT STRUCTURE

Users of financial information may notice that most corporate annual reports have similar reporting structures. There are two main reasons for this likeness. First, consistency in the reporting structure allows a seasoned or novice user to easily locate information. Knowing where to look improves the usefulness and value of the information. Second, disclosure rules require specific types of information to be included in the annual report. This assures investors and others that companies will address similar topics, as well as provide supplemental disclosure where necessary.

You read and interpret the key sections in the annual report at this time. Knowing what to look for and where to find specific information in the annual report is a skill all business professionals should possess.

Financial Highlights

Frequently, the annual report to the shareholders opens with a presentation of financial highlights or selected statistical data. This typically includes performance measures such as comparative sales, net earnings, per-share information, and possibly some key financial ratios or other company statistics over time. Bar and pie charts visually enhance the presentation of selected highlights. A company's financial highlights represent a subset of more detailed information that follows in later sections of the annual report.

Financial highlights are presented early in the report in an effort by management to make the company look as good as possible. The message may or may not be an accurate reflection of the company. Therefore, do not rely on this information alone to make a decision about the company. View this information as a biased introductory summary.

Chapter 2: Financial Highlights – Question 1

Review the financial highlights of your company's annual report to the shareholders. Identify net sales or revenues, net income, basic earnings per share (BEPS), and total assets for the current and preceding years. These are the most common values included in financial highlights. If your company reports something different, simply cross out an item here and recap what is reported. SEC Form 10-K does not provide financial highlights. You may find this information on the company website. If not available put N/A in the first row of boxes.

Categories	Current Year	One Year Prior	Two Years Prior
Net sales or revenues			
Net income			
Basic EPS			
Total Assets			

Based on your preliminary review, is your company performing better than, equal to, or less favorably than in the prior year? Briefly explain.

General Company and Marketing Information

Management uses the annual report to the shareholders to market the company's products and services, and enhance its image. You will find information throughout the annual report to shareholders about company volunteer activities, employee relation programs, and research and development success, for example. These voluntary disclosures are intended to improve the company's image. You are likely to find that colorful pictures and fancy charts and graphs are used to communicate a variety of messages. If this information is not available in the annual report, then search the company website and respond accordingly.

Chapter 2: General Company and Marketing Information – Question 1 Look for pictures of product and people that are colorful and send a positive company signal to the reader.	
Category	**Message**
Example: Volunteer Activities	Ongoing and contributing to the success of the community
What is the broader message from this information?	

Management's Discussion and Analysis

The *management's discussion and analysis of results of operations and financial condition* (MD&A) report is considered by many to be one of the most important components of the annual report. As a result, we have seen a significant increase in the length of this section, a trend that is likely to continue under the current climate of financial reporting.

The SEC requires management to discuss the company's prior and current performance so that readers can gain insight into what management perceives the direction of the company to be. This is important to the user for two reasons. First, it makes explicit how successful leadership has been at achieving the corporate strategy and points to the company's future strategic focus. Second, this information helps the user of the annual report compare and contrast the company's corporate strategy to its available resources.

With the MD&A report management is expected to address three important areas: results of operations, capital resources, and liquidity. Typically the report begins with an analysis of prior, current and future results from operations, i.e. performance. Next, in the MD&A, is a disclosure about cash availability. A short-term cash perspective is discussed with disclosures on liquidity. A long-term cash perspective is discussed with disclosures on capital resources.

Chapter 2: Management's Discussion and Analysis – Question 1
Results of Operations: Identify the primary drivers/issues that explain current and future results of operations discussed in the MD&A. For example, the gross profit percentage increased because of improved buyer/supplier relations resulting in greater overall operating performance. Or an increase in operating expenses because of increased fuel costs reduced profits. List the six major drivers/issues of performance you find in the MD&A section of the annual report.

1.
2.
3.
4.
5.
6.

Liquidity: Recap what you find about your company's liquidity in the MD&A section of the annual report. Look for information about the ability of the company to satisfy short-term cash needs and the ability to generate operating cash flows, for example.

Capital Resources: Recap what you find about your company's capital resources in the MD&A section of the annual report. Look for information about cash reserves and credit availability. For example, your company's MD&A section may have a disclosure about an established line of credit to fund future growth.

Reports by Management

Management files additional reports in the annual report to be in compliance with reporting requirements mandated by the Sarbanes-Oxley (SOX) Act of 2002. The reports are designed to make explicit that management is responsible for internal controls and the financial statements. The reports are also intended to help the user recognize that the independent accountant is not responsible for internal controls and the financial statements.

Chapter 2: Reports by Management – Question 1 Review the Management's Report (Responsibility) on Internal Control over Financial Reporting in your company's annual report. Answer the following questions.	
Who is responsible for maintaining the internal controls designed to provide reasonable assurance that the books and records reflect the transactions of the company?	

Record the statement that identifies management's conclusion about internal controls.	
Who audited management's assessment of the effectiveness of your company's internal control over financial reporting?	

Independent Auditors' Report

An outside accounting firm issues the independent auditors' report to the shareholders and board of directors of the client corporation. It must be signed and dated by the accounting firm that conducted the audit. This report provides important information and should be read before one interprets the financial statements. All material reporting deficiencies are disclosed in the report and should be taken into account before an analysis of the financial information. Most audit reports are divided into three paragraphs, each addressing an important audit issue.

Chapter 2: Independent Auditors' Report – Question 1 Review the Independent Auditors' Report of your company's annual report and answer the following questions.	
Who was the company's auditor and where is it located?	
What is the responsibility of the auditor?	
Who is responsible for the preparation of and information within the company's financial statement?	
The audit was conducted in accordance with what?	
What was the opinion of the auditor?	

Financial Statements and the Related Notes

A significant component of the annual report is devoted to a presentation of the company's financial statements, which normally includes a *consolidated statement of income (earnings),* a *consolidated balance sheet,* a *consolidated statement of cash flows,* and a *consolidated statement of change in stockholders' equity*. (Consolidated statements include the results of the parent and all subsidiaries.) The purpose of each financial statement is addressed as follows:

- *Statement of income (earnings)*. Reports a company's financial performance over a period of time.
- *Balance sheet*. Reports a company's financial position on a particular day.
- *Statement of cash flows*. Reports a company's cash inflows and outflows over a period of time.
- *Statement of change in stockholders' equity*. Reports changes to stockholders' equity accounts over a period of time.

Each of these financial statements will be addressed in Chapter 3, as well as the notes to the financial statements. Notes to the financial statements are just as important as the financial statements themselves because they provide a more detailed explanation of the numbers.

Five- or Ten-Year Summary of Operating Results

The SEC requires a company to include a five-year summary of selected financial and nonfinancial information in the annual report. Summary information gives the investor and other users the opportunity to identify emerging trends and better understand where the company has been and where it is going, in one convenient location. Many analysts use this report to identify pending weaknesses or strengths. Often, companies extend the five-year comparative to include ten years of information.

Analysts and other users should exercise caution when they review these statistical summaries. ***This report may or may not be covered by the auditor's opinion (Statement on Auditing Standards No. 131, January 2016)***. In addition, management selects the information included in this report. Information presented in the summary may be extensive for some companies and limited in others. The five- or ten-year summary typically includes comparative sales and earnings information as well as measures of financial position such as total assets, working capital, total debt, shareholders' equity, and selective nonfinancial information.

Chapter 2: Five- or Ten-Year Summary of Operating Results – Question 1 Identify the major components provided in the five- or ten-year summary. Summarize the insight provided by each. Look for stable, increasing or decreasing trends. Consistent, slightly improving performance signals management has control of the business. Inconsistent performance signals management does not have control of the business.	
Component	**Summary of Insight**
Example: The Home Depot	Sales and earnings have grown significantly over time. Operating expenses are decreasing.

Shareholder Information

Annual reports close with a section devoted to investor and company information (discussed in Chapter 1). Although this section is included at the back of the annual report, the placement should not diminish its importance.

Wrap-up

Observe that the annual report is a tool that frames past successes and failures and future activities within a company's strategic focus. This section of the workbook stepped you through the many components of the annual report. The vast majority of annual reports will have similar sections. Each company will deliver its information differently, however. It is the consumer's responsibility to apply this information in support of his or her individual decision-making needs. Critical analysis occurs when you compare the qualitative information gathered up to this point with the financial information you pull together in Chapters 3 and 4. This is where a sound grasp of the language of business, accounting, serves the user in decision making.

Your distinct challenge is to determine if the company has the financial resources to move forward with its corporate strategy. For you to evaluate this issue, a command of the financial statements is essential. The following chapters build the tools to follow through with a sound, systematic framework for financial analysis.