

[Previous Page](#)

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## Fool.com: 10 Things to Look for in an Annual Report [Special] March 22, 2001

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As many investors are aware, springtime is annual report time, when mailboxes across the land become clogged with flashy reports from public companies of all stripes. While the average corporate annual report includes plenty of PR, it can also contain a wealth of useful information for the individual investor, whether you're already a shareholder or are researching the company as a potential investment (in which case you can request an annual report from the company or find it on their website).

Yet, while annual reports may be a crucial resource, they're generally not organized in an investor-friendly manner. Much of the useful information is in small print on plain paper, buried behind glossy photos and other distractions. Therefore, to help you get the most out of them, we present 10 things investors should look for in annual reports.

### 1) The two halves of an annual report

We'll begin with a basic pointer: When you check out an annual report, keep in mind that there are basically two parts: the glossy part up front, where you have plenty of soundbites, impressive photography, and carefully selected financial figures, frequently illustrated with bar or pie charts. The second half is the "Joe Friday," just-the-facts-Ma'am part, consisting of financial statements and a discussion of recent results from management. The second half usually includes more useful information, but it's worth checking out both parts.

### 2) An Informative Letter to Shareholders

The slick first half kicks off with the Letter to Shareholders, usually from the CEO. These can range from hot-air hype to informative discussions of a company's business. The most famous of these is Warren Buffett's in the **Berkshire Hathaway** ([NYSE: BRK.A](#)) [annual reports](#), which are not only excellent sources of information about the company but also include plenty of investing insights.

While few shareholder letters are quite as well-known or as educational (or as long) as Buffett's, most are worth checking out. For example, **Cisco Systems'** ([Nasdaq: CSCO](#)) includes plenty of interesting tidbits, including several that illustrate the company's internal efficiency, such as the fact that in fiscal 1999, 90% of customer orders were transacted over the Internet.

### 3) Cool photos (Not)

While glossy annual reports may be impressive, a plain vanilla, straightforward report is in many ways preferable. After all, annual reports cost the company money, but they are distributed for free. Therefore, it's not necessarily in your interest as an investor to have your company produce a slick annual report.

Plenty of firms produce plain reports that simply include the annual 10-K [SEC filing](#), as well as a Shareholder's Letter and maybe one or two other items. Examples include discount warehouse club **Costco** ([Nasdaq: COST](#)), and of course Berkshire Hathaway, which would sooner close down than include a photo or color graphic of any kind in their annual report.

Just to be contrarian, though, it's worth putting in a word for excess in annual reports. **Human Genome Sciences** ([Nasdaq: HGS1](#)) is one of the most impressive in this respect (or worst offender, depending on your view), including copies of about 20 Renaissance [art works](#) in its annual report.

(Our favorite is probably Pietro Berrettini's "Venus Hunting Appears to Aeneas," c. 1650.) And after all, you really can't expect **Martha Stewart Omnimedia's** ([NYSE: MSO](#)) [annual report](#) to be plain or boring.

#### 4) Relevant financial data

Most annual reports include some financial numbers in the glossy pages, which are usually carefully selected to put the company in a positive light. Sometimes, however, there will also be figures distinct to the company's business, such as market share claimed by particular products, or a geographic breakdown of revenues and earnings.

For example, want to know **Sun Microsystems'** ([Nasdaq: SUNW](#)) share of the Unix-based server market (one of its lead products)? It's on page eight of this year's [report](#) (28% in 1999). Of course, market share numbers can be massaged in plenty of different ways, so take them with a grain of salt.

#### 5) Explanations of the business

A good annual report can also teach investors plenty about the business in question, particularly if that business is a relatively complicated one. The best ones will have explanations of what the company does, and useful examples of how it makes money.

**Nokia's** ([NYSE: NOK](#)) current [annual report](#) (what it now calls its "Business Review") is an excellent primer on the current state of the mobile handset market. It includes interesting info (for example, only 10 million people in the world had mobile phones in 1992, while the company estimates that one billion will have them by 2002), as well as clear explanations of many wireless technologies.

#### 6) Management's Discussion and Analysis of Financial Condition and Results of Operations

Once you get into the nitty-gritty second half of an annual report, usually the first thing you'll see is a section with a scintillating title similar to the one above, and with lots of small print, all of which looks boring. Nevertheless, it isn't. The "MD&A," which is what the cool kids call it, is a much more straightforward accounting of what kind of year the company had than all the PR you find in places like the Letter to Shareholders.

A solid MD&A will include everything from a comprehensive description of the business -- **Johnson & Johnson's** ([NYSE: JNJ](#)) is an excellent [example](#) -- to financial information about different business segments, to straightforward reviews of sales and expenses. In addition, this section can also include information the company doesn't want to highlight, such as the cost of acquisitions or one-time charges that are always "excluded" in the press releases, but that can still have significant effects on the business.

#### 7) Financial Statements

If you've invested in a company, then ideally you're already familiar with its income statement, balance sheet, and cash flow statement (if not, don't worry, we won't tell anyone!).

Either way, [financial statements](#) are to the financial charts and graphs in the glossy pages up front what the MD&A is to the Letter to Shareholders -- the real deal behind the company's public face. Not only do you get the basic financials mentioned above, but usually more detailed info about things like changes to shareholder's equity. In addition, a good annual report will also include more historical data, with the best reports giving 10 years' worth of financial information.

#### 8) Notes to Financial Statements

If there's one thing that seems even less inviting than the MD&A, it's the "Notes to Financial Statements." However, investors shouldn't ignore them.

Not that anyone expects you to read every last word, but the Notes usually include such valuable information as a company's revenue recognition policy and its allowance for doubtful accounts (in other words, how much of its accounts receivable it has estimated it won't collect). In addition, info on taxes and stock option grants can also be gleaned from the Notes. The fact that most people do not read them is what makes them so useful. So, the next time you need some night-time reading,

curl up next to the Notes to the Financial Statements and learn about all of the subtle or not-so-subtle transactions and events shaping the companies you own.

### 9) Who is the CEO?

While it can be hard to pick out from the dry language of an annual report, it's always interesting when some signs of a CEO's personality pop up.

For example, last year's shareholder [letter](#) from the Chairman and CEO of **Tellabs** ([Nasdaq: TLAB](#)), Michael J. Birck, is a lot more straightforward and heart-felt than the average. He points out mistakes the company made and why it made them. He also talks of the future -- the distant future -- and how Tellabs is gearing up for it.

But the best line is in reference to a retiring board member, who he refers to as a "free thinker," indicating an appreciation for a truthful lieutenant over a "yes-man." Too many executives fly around on their private jets convincing themselves they are *Masters of the Universe* while creating an environment filled with politics and pleasantries. Mr. Birck's letter reveals a passion for the company he helped build; it reveals that he still works there because he wants Tellabs to succeed, not to feed his ego.

### 10) And last... the unusual

Even harder to find are entire annual reports that deviate from the norm. Certainly the most unfortunate byproduct of the purchase of ice cream makers Ben and Jerry's by the international conglomerate **Unilever** ([NYSE: UL](#)) is the loss of the Vermont company's take on this corporate ritual.

The company's 1996 annual report (yes, printed on recycled brown paper) is noteworthy (or maybe just amusing) for its unique touches, such as a "social report" four times longer than the MD&A. In the Social Report, you can find Ben & Jerry's progress on "gender pay equity," its energy consumption, and the gallons of dairy waste it discharges to the municipal plant. That's something you won't get from the average blue chip.

### Conclusion

In short, annual reports are a great resource, and investors should take advantage of them. If we missed anything in this list, let us know on the [Specials](#) discussion board!

*Chris Rugaber, who put this article together, owns shares of Human Genome Sciences, Cisco Systems, Tellabs, Sun Microsystems, Costco, Martha Stewart Omnimedia, and Berkshire Hathaway. He is not trying to hype these stocks, but is just using their annual reports as examples. [Todd Lebor](#) wrote about Tellabs, which he does not own. [John Del Vecchio](#) did not mention any companies in his section on the Notes to the Financial Statements. Click the writers' names to see their holdings, or check out the Fool's [disclosure policy](#).*

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[Previous Page](#)