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Understanding Annual Reports of Hospitality Firms

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Understanding Annual Reports of Hospitality Firms

Abstract

In her discussion - Understanding Annual Reports of Hospitality Firms - by Elisa S. Moncarz, Associate Professor, School of Hospitality Management, Florida International University, Associate Professor Moncarz initially offers: "Management bears full responsibility for the reporting function of annual reports prepared by publicly-held companies designed to provide interested parties with information that is useful in making business and economic decisions. In Part I the author reviews the content of annual reports of firms in the hospitality industry, while looking at recent developments affecting annual reports. Part II, in a subsequent issue, will comprise an in-depth examination of the annual report of an actual firm in the hospitality industry, focusing on suggested guidelines and recommendations for how to use annual reports as an aid to the decision-making process in the hospitality industry."

This article is to be considered a primer on reading and understanding annual reports, as well as a glimpse into the dynamics that affect them.

In defining what an annual report is, Associate Professor Moncarz informs you with citation, "Annual reports are required by the Securities Exchange Commission (SEC) ¹ for all companies with securities sold to the general public. These reports, which must be issued within 90 days after the close of the calendar (or fiscal) year, comprise a primary source of information about these companies," she further reports. "Indeed, the official version of the company's history is summed up yearly in its annual report by providing full information of the company's operations over the period as well as what the company is gearing up to accomplish in the next year," Professor Moncarz closes the definition.

Why should this happen over and above SEC requirements? The financial component is an important one; the author offers her informed view: "The major objective of financial statement reporting is to provide information that is useful to present and potential investors, creditors, and other financial statement users in making rational investment, credit, and similar decisions. Thus, financial statements represent the primary (and most reliable) source of knowledge about a particular firm in the hospitality industry." The above two paragraphs crystallize the requirement and the objective of annual reports.

"A typical annual report of a hospitality firm contains a number of standard features which may be broken down into the following three sections ..." General, financial data, and supplementary data are variously bounded and circumscribed for you.

As a marketing device and feel-good initiative, the annual report is a useful tool for a hospitality corporation that is in-the-black, and focused on the future, says the author. She cites the Marriott Corporation's 1985 annual report as an example. Of course, an annual report can also be a harbinger of bad news for shareholders as well.

Notes/footnotes and disclosure are key elements to the credibility of any annual report; Professor Moncarz discusses these concepts at length.

"Given the likelihood that the hospitality industry will continue to face an uncertain economic environment for some time, financial statement users should become more demanding in their need for information that will help assure the firm's survival and evaluate its ability to

generate earnings, increase the firm's investment value, and provide for its future growth,” Professor Moncarz says. “Accordingly, understanding annual reports in the hospitality industry should become even more critical.”

Keywords

Elisa S. Moncarz, Understanding Annual Reports of Hospitality Firms, SEC, Financial Accounting Standards Board (FASB), Generally Acceptable Accounting Principles (GAAP), Disclosure, FIU

Understanding Annual Reports of Hospitality Firms

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Management bears full responsibility for the reporting function of annual reports prepared by publicly-held companies designed to provide interested parties with information that is useful in making business and economic decisions. In Part I the author reviews the content of annual reports of firms in the hospitality industry, while looking at recent developments affecting annual reports. Part II, in a subsequent issue, will comprise an in-depth examination of the annual report of an actual firm in the hospitality industry, focusing on suggested guidelines and recommendations for how to use annual reports as an aid to the decision-making process in the hospitality industry.

Before granting a loan, making an investment, or accepting a professional management position with a major firm in the hospitality industry, prospective creditors, investors, and professional managers alike will want to know about the firm's business, history, current position, and future plans. A key determinant will be the quality or ability of management to generate sales revenue, control expenses, manage the firm's resources, and provide for its future growth. In their evaluation of these data, all interested parties will rely heavily on the annual report published by the firm at the end of each year and sent to its shareholders.

Annual reports should provide answers to such questions as the following: Is this a sound investment? Is this a good place to work? What is the company's financial condition? How well is the company really doing? What are the prospects for future growth? The annual report includes an in-depth coverage of the hospitality firm's operations and financial status, as well as its future development plans.

Nonetheless, many readers perceive the information contained in annual reports as overwhelming. As a result, many intended users have stopped reading annual reports, while others have given up on understanding them. It has been argued that an average investor, for instance, spends less than 15 minutes on the annual report, thereby not receiving the necessary information about the company that will serve as a basis to a sound business decision.

Annual Reports Inform and Promote

Annual reports are required by the Securities Exchange Commission (SEC)¹ for all companies with securities sold to the general public.

These reports, which must be issued within 90 days after the close of the calendar (or fiscal) year, comprise a primary source of information about these companies. Indeed, the official version of the company's history is summed up yearly in its annual report by providing full information of the company's operations over the period as well as what the company is gearing up to accomplish in the next year.

This shareholder's annual report, along with certain supplementary information, must be included in the annual filing with the SEC known as Form 10-K report. The 10-K report is available to the general public upon request. Yet, few shareholders and other interested parties take advantage of this opportunity.

Companies have long sought to look their best in annual reports. In so doing, many companies have been using annual reports to promote themselves in an attempt to look good, to place their best foot forward.² As a result, some observers have been critical of annual reports, claiming that they are too self-serving. Furthermore, financial analysts maintain that in recent years, as economic pressures have mounted, the reports are going much further than ever in hiding bad news, leaving out some important information or making misleading comments. For example, when an annual report starts off "last year was a year of transition for the company," it normally means that the company incurred major losses. Conversely, when the transition is upward, the annual report would address this positive trend directly, in plain English.³

Reports Have Several Standard Features

A typical annual report of a hospitality firm contains a number of standard features which may be broken down into the following three sections:

- **Section I - General**

- President's letter
- Operational and financial review
- Summary of selected financial data
- Graphs and charts
- Other company information

- **Section II - Financial Data**

- Financial statements (i.e., balance sheet, statement of earnings and statement of changes in financial position)
- Auditor's opinion letter
- Company's representation
- Management's discussion and analysis

- **Section III - Supplementary Data**

- Corporate information (e.g., listing of officers and directors)
- Investors' data
- Development activities
- Segment reporting
- Environmental and other social costs

The letter from the president and/or chairman of the board points out a general picture of corporate progress while anticipating the business climate for the upcoming year. The information contained in this letter

tends to be upbeat and positive, emphasizing all the company's strengths while not directly disclosing negative trends or weaknesses. In such cases the sophisticated reader must turn to the financial statement section to fully understand what actually happened to the financial position and operating performance of the hospitality firm under study.

In the president's letter to Marriott Corporation shareholders included in the 1985 annual report, J. W. Marriott, Jr. starts his message brimming with confidence about the corporation's leadership position in the hospitality industry. Marriott stresses the high level of sales and return on equity, and the rise in Marriott's net income during 1986. No specific mention was made, however, that Marriott's return on equity of 21 percent in 1986 (though high) had actually decreased from 22.1 percent in 1985, or that Marriott's profit margin had actually declined in 1986 since the increase in net income was lower than the increase in sales for the year 1986.

On the other hand, the chairman of the board of Ramada, Inc. emphasized in a letter to shareholders (included in Ramada's 1986 annual report) the strategic plan for Ramada through 1991 with its "overriding goal of transforming Ramada into a world class hospitality company." There was no disclosure of the decline in net income, earnings per share, and return on investment experienced by Ramada during the year 1986. In order for a prospective creditor, investor, or professional employee to become aware of those crucial facts, an in-depth analysis of the annual report's financial section is required.

The president's letter to the shareholders is followed by an overview of specific operations, new markets, acquisitions, divestitures, and management changes. Again, this data will emphasize all the company's strengths. A table of financial highlights is normally included on the first page or inside covers. Some firms may drop this table in years when declining or negative results are present.

Financial Statements Are Backbone

The major objective of financial statement reporting is to provide information that is useful to present and potential investors, creditors, and other financial statement users in making rational investment, credit, and similar decisions. Thus, financial statements represent the primary (and most reliable) source of knowledge about a particular firm in the hospitality industry. They are the center of gravity on annual reports. Yet, complaints that the basic financial statements (especially the footnotes) have become too complex to be readily understood, even by sophisticated users of annual reports, have not been uncommon.

A complete set of financial statements in a hospitality firm's annual report includes the balance sheet with its supporting statement of shareholder's equity, the statement of earnings, and the statement of changes in financial position.

The balance sheet, also called statement of financial position, summarizes the financial condition of the hospitality enterprise at a moment in time (the last day of the year). It consists of three main categories: the company's resources (assets), what it owes (liabilities), and the remaining equity of the shareholders in the business (shareholders' equity). By

studying the balance sheet, lenders, investors, professional managers, and others are able to measure the company's liquidity position and its ability to generate earnings and pay dividends. The relationship of current assets to current liabilities, for instance, indicates the firm's ability to pay its obligations on a current basis. Through the use of various tools and techniques of financial analysis (e.g., ratio analysis), the prediction of bankruptcy (one of the most serious events a firm faces) should be a great interest and concern to all users of financial statements, especially management. In fact, during inflationary, recessionary, or uncertain economic conditions (such as the one following the recent stock market crash of 1987), many financial statement users will focus on the balance sheet as a predictor of a company's survival.

Income Statement Measures Performance

The ability of management to generate sales revenue, control expenses, and thereby earn a profit (net earnings) is measured by the income statement, also referred to as statement of earnings.

Hospitality firms hope that revenues will be greater than expenses, so that a net difference, called net earnings or net income, will result. This excess of revenues over expenses (or net income) will hopefully be large enough to provide a reasonable return on investment for the owners of the hospitality firm.

The statement of earnings tells its readers how well the hospitality firm performed during the year as compared with prior periods. The bottom line is net earnings, which is the final earnings after all costs and expenses are deducted from sales revenue. Preoccupation of investors and corporate managers is, however, with a single income statistic, namely that of earnings per share of common stock outstanding.

In analyzing the statement of earnings, a careful distinction must be made between operating income and net earnings. To illustrate, Pan American Airways reported net earnings of \$80.3 million in the early 1980s following the acquisition of National Airlines. Nonetheless, they had an operating loss during that year, which was offset by a gain of \$294.4 million from the sale of the Pan American building in New York City, resulting in the reporting of net earnings on the income statement. Hence, this non-operating gain distorted an otherwise normal trend (i.e., negative) of earnings in which the Pan American statement reader was so interested. Without this non-operating income, Pan American would have reported a net loss of \$214.1 million in the 1980 income statement.

Funds Statement Summarizes Financing and Investing

The statement of changes in financial position, traditionally known as the funds statement, has been perceived as a bridge between the income statement and the balance sheet. It serves as a summary of all the financing and investing activities that affected the financial position of the hospitality firm during the year. It reflects the sources and uses of funds, showing specifically where the resources have been obtained and how they have been used by management.

The statement of changes in financial position adds significantly to the understanding of what happened to the hospitality firm during the

year, providing more reliable and credible evidence of the company's activities and intentions than any statements or speeches by its management (e.g., the president's letter included in the first few pages of the annual report).

In examining the details of the statement, owners, creditors, and others can obtain data concerning changes in the firm's financial position during the year. The funds statement shows how the company financed its growth, that is, internally (from operations) or externally (e.g., debt, selling stock, disposing of property and equipment). Likewise, the statement of changes in financial position serves as a basis to evaluate the handling by management of resources available to them. While some investors are mainly concerned with dividends, others are concerned with the company's long-term growth and the resultant expected increase in the value of their stock. Thus, these parties are interested in how the company uses the resources that are not being distributed to investors in the form of dividends (e.g., for expansion, to acquire other firms, to repay debt, to repurchase stock).

The statement of changes in financial position also provides clues to future concerns, such as the ability of the firm to pay dividends, to expand, to meet debt obligations, and so forth.

Since 1980 the Financial Accounting Standards Board (FASB)⁴ has been involved in a project to replace the statement of changes in financial position with a cash flow report. A proposal for a cash flow statement, rather than the traditionally required working capital approach in the preparation of the statement, was first advanced in a November 1981 proposal which received widespread support. As a matter of fact, the Financial Committee of the American Hotel and Motel Association has been recommending the cash flow focus in the preparation of the statement of changes in financial position for the hospitality industry.

As of this writing, it is expected the FASB will enact a final pronouncement which would require a statement of cash flow as part of a full set of financial statements of all business enterprises for fiscal years ending after July 15, 1988. Accordingly, the current format of the statement of changes in financial position (e.g., working capital focus) would be replaced by a funds statement with a cash flow focus.

Notes Are Integral Part of Financial Statements

Notes to the financial statements (often referred to as footnotes) amplify and clarify the information contained in the three basic financial statements. They are governed by the basic accounting principle requiring the full disclosure of all facts needed by statement users to reach informed conclusions and thus make financial statements that are fair and not misleading.

The notes to the financial statements cover a multitude of subjects necessary for adequate disclosure, such as explanatory detail of the composition of assets and liabilities, recognition of revenue, etc.

The following are some footnotes that are worthy of specific mention.

- **Summary of significant accounting policies:** This first note includes "information about the accounting policies adopted by the repor-

ting entity that is essential for financial statement users.”⁵ This information includes the disclosure of the basis of preparation of consolidated financial statements, methods of determining inventory cost and depreciation, and basis for revenue recognition and related costs (e.g., franchise fee revenue, casino win, promotional allowances). Thus, the information in the statement of accounting policies is fundamental for understanding and evaluating the data contained in the financial statements. It will also be helpful in assessing the credibility and quality of earning and in providing comparative analysis.

- **Commitments and contingencies:** An examination of commitments and contingencies is vital in assessing earnings prospects and probable future success of the hospitality company. Contingencies refer to existing conditions whose ultimate effect is uncertain, and their resolution depends on specific future events. They include the co-signing of a note by another party, pending lawsuits, and tax assessments. The major commitments disclosed by a hospitality firm are leasing and construction commitments, and restrictions pursuant to the terms of long-term debt agreements.

- **Segment reporting:** Disclosure of revenue, operating earnings or losses, identifiable assets, depreciation expense, and capital asset expenditures related to each segment or industry in which the hospitality enterprise operates.⁷

- **Subsequent events:** Disclosures of significant events that have occurred subsequent to the balance sheet date are required to prevent the financial statements from being misleading. Examples are the acquisition of new companies, fire losses, settlement of litigation, and issuance of bonds and capital stock.

- **Pension and stock option plans:** When applicable, disclosure of the nature and status of the firms’ pension and/or stock option plans, describing the employee groups covered, plan policies and other pertinent data.

- **Supplementary information:** These data discuss the effects of inflation on operating and financial data.

- **Income taxes:** Disclosure of significant amounts of unused credits, the nature of differences between pre-tax accounting income and taxable income, and tax effects of timing differences.

As noted above, an in-depth review of the notes to the financial statements is essential for a complete and accurate interpretation of the hospitality firm’s financial and operating information. Some analysts have argued, however, that incomprehensible footnotes (too technical and/or awkward) have been quite prevalent in annual reports, especially related to sensitive areas, such as lawsuits or ventures that have been abandoned with heavy losses. This has been perceived as a major obstacle in understanding the information contained in the financial statements.

Management Must Discuss Finances and Performance

For several years publicly-held companies have been required to include a discussion of management's view of the company's financial position and performance in their annual report to shareholders.⁸ This is normally done in a separate section of the annual report headed "Management's discussion and analysis." The SEC takes its enforcement responsibility with respect to this section seriously insofar as material omissions and misstatements.⁹ Therefore, management's review and analysis must be based on information, assumptions, and interpretations made in good faith, and in a reasonable manner.

The subjects to be included in management's discussion and analysis include liquidity, capital resources, results of operations, forward-looking information, and inflation. Full, forthright, and open discussion of the factors affecting both current and future operations is expected. Management should attempt to reconcile underlying causes and economic influences with any changes in sales, expenses, and net income. Matters that are expected to impact financial operations are of prime importance, for instance, the introduction of a new product, the discontinuances of major products, and the disposal of a major segment of the hospitality firm. Firms are required to make full disclosure of adverse as well as favorable trends.

Management must publicly accept responsibility for financial statements since the primary responsibility for the integrity of the hospitality firm's financial statements rests with them. By responsibility it is meant the obligation to make full disclosure of all material facts, to make financial statements fair and not misleading, and, in general, to tell the whole truth. Too little disclosure, such as withholding information about a major lawsuit against the hospitality company, would be misleading, and top managers are held generally liable for this lack of disclosure.

CPA's Opinion Adds Credibility

Publicly-owned hospitality firms are required by federal securities laws to have the financial statements included in their annual reports audited by an independent public accountant or CPA. In this way, the expression of an opinion on the fairness of financial statement presentation by the CPA firm provides shareholders, absentee owners, lending institutions, and others with a reasonable degree of assurance as to the validity of the information contained in the financial statements, which, as we know, are the responsibility of management.

In order to form a basis for the expression of an opinion on the financial statements, the CPA firm conducts an independent audit. The audit steps entail the inspection and observation of invoices, bank statements, and other internal evidence, as well as external inquiries. This independent audit comprises the application of statistical concepts that enables auditors to form judgment on the whole based upon information provided from samples.

Based on the results of this independent examination, the CPA firm determines whether or not the hospitality firm has prepared the financial statements in accordance with generally acceptable accounting prin-

ciples (GAAP), and whether the statements present fairly the financial position and the results of operations of the hospitality firm for the periods covered. Yet, creditors, investors, professional managers, and other interested parties need not be concerned about how an audit is actually performed. The bottom line to them is the opinion of the CPA which will serve as a basis that financial statements can be relied upon for numerous decisions, such as buying and selling the stock of the company, lending funds to the hospitality firm, and determining if the company is in compliance with regulations of certain government agencies. It is important to note, however, that in expressing their opinion on the hospitality firm's financial statements, "the independent auditors judge neither the legal aspects or the wisdom of management's actions. Nor do CPAs attest to the corporation as being a good or bad investment."¹⁰ Notwithstanding this, external parties will place reliance upon the company's financial statements because the annual report contains the CPA's unqualified (clean) opinion, which is in effect saying that the CPA firm is satisfied that the financial statements have been prepared in accordance with GAAP and are fairly and consistently presented.

Because of the importance of the auditor's opinion, the AICPA and other accounting and reporting authorities have recommended a certain degree of uniformity in wording the CPA's opinion letter, often referred to as the auditor's report. The first part of the CPA letter, the scope paragraph, goes on to state that the auditor has performed certain tests of the accounting records and other audit procedures that were considered necessary. In the opinion (and last) paragraph of the short-term auditor's report, the CPA, considered the professional expert in accounting, states that the financial statements are fairly and consistently presented in conformity with GAAP.

Although the independent auditor does not certify that the statements are correct or guarantee them to be true (a common misunderstanding), there are a number of implicit assumptions contained in the CPA's opinion letter. It is implied that all disclosures necessary for fair presentation were made. It is implied that the internal control of the hospitality firm is satisfactory for the auditor to rely on the accounting data. Finally, it is implied that the books and records of the client reflect the values on the financial statements.¹¹

As an example, Coopers & Lybrand, the auditors of Ramada, Inc., expressed an unqualified opinion on the auditor's report included in the company's 1985 annual report. In their opinion, Ramada's financial statements were prepared in accordance with GAAP, presenting "fairly" and consistently the financial position, results of operations, and changes in financial position of Ramada, Inc. for the period covered.

When the independent auditors are not in a position to issue an unqualified or clean opinion on the financial statements of the hospitality firm, three choices are available to them: a qualified opinion, a disclaimer of opinion, or an adverse opinion. A qualified opinion may be issued when, despite certain reservations, the financial statements present fairly the financial condition and results of operations of the hospitality company. The standard short-form report is modified to inform the reader of the

qualification by using phrases such as "except for" and "subject to." Examples of events requiring qualified opinions would be changes in accounting principles and inadequate disclosure.

When independent auditors are unable to express an opinion on the financial statements, it is referred to as a disclaimer of opinion. The CPA firm must state in a separate paragraph of the report the reasons for issuing the disclaimer. These reasons may include restrictions placed on the scope of the auditor's examination and inadequate or incomplete accounting records.

If in the professional judgment of independent auditors, the financial statements taken as a whole are not fairly presented, then an adverse opinion must be issued. Auditors must express their reasons for issuing an adverse opinion in the auditor's report. Adverse opinions can be very damaging to the firm. Yet, they are very rare. Indeed, in the presence of an opinion that is other than unqualified (qualified, disclaimers, or adverse opinion), present and prospective investors, professional managers, creditors, and others should proceed with caution. Readers should fully understand the reason(s) given by the auditors for their reluctance to issue a clean opinion on the fairness of the hospitality firm's financial statement presentation.

Annual Reports May Change

The content of annual reports is expected to become even more controversial in the foreseeable future.

Since production costs of annual reports filled with expensive photos, charts, and graphs have skyrocketed in the recent past, a number of companies had been asking the SEC to permit an abbreviated annual report to shareholders that would cut down the cost of annual reports. Recently, the SEC gave permission to General Motors to issue a "Summary Annual Report" for 1987. It is anticipated that this SEC action will result in other companies following suit by issuing summary reports for 1987.¹² Although the actual financial statements cannot be reduced, companies are expected to eliminate or reduce detailed information on lease commitments, long-term debt, and description of subsidiaries, operations, and business segments.¹³ Yet, many analysts feel that a summary annual report will only permit more abuses and reduce already minimal disclosure of critical data needed for decision-making purposes.

Moreover, the recent stock market crash has re-focused attention on the need for financial and operating information along with a more candid and analytical assessment of management's ability to survive in a competitive and changing hospitality environment. As a result, the extent of information needed by investors, creditors, absentee owners, and others in evaluating the financial and operating status of the hospitality firm has never been more extensive.

Given the likelihood that the hospitality industry will continue to face an uncertain economic environment for some time, financial statement users should become more demanding in their need for information that will help assure the firm's survival and evaluate its ability to generate earnings, increase the firm's investment value, and provide for its future growth. Accordingly, understanding annual reports in the hospitality industry should become even more critical.

References

¹A federal agency that has the responsibility for setting accounting and reporting standards for business organizations in the United States. The SEC has delegated most of this responsibility to the FASB, an independent private sector organization.

²Lee Berton, "Best Foot Forward—the Annual Report is short on candor," *The Wall Street Journal*, (September 9, 1987), p. 1.

³Mitchell M. Krasnoff, "Have financial statements become too cluttered?" *Laventhol & Horwath Perspective*, (Fall-Winter 1979), p. 33.

⁴The independent private sector organization that now sets United States accounting standards.

⁵American Institute of Certified Public Accountants, *Accounting Principles Board Opinion No. 22*, "Disclosure of Accounting Policies," (April 1972), p. 8.

⁶Elisa S. Moncarz and Nestor de J. Portocarrero, "*Financial Accounting for Hospitality Management*," (Westport, Conn.: AVI Publishing Company, 1986), p. 442.

⁷*Ibid.*, p. 443.

⁸John W. Bagby and Phillip L. Kitzele, "Management Discussion and Analysis: Discretionary disclosures and the business segment," *Accounting Horizons*, (March 1987), p. 51.

⁹*Ibid.*, p. 56.

¹⁰Jack L. Smith and Robert M. Keith, "*Accounting for Financial Statement Presentation*," (New York, NY.: McGraw Hill, 1979), p. 121.

¹¹*Ibid.*, p. 177.

¹²Berton, *op. cit.*, p. 25.

¹³*Ibid.*, p. 1.