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Abstract

This is the second article in a two-part series on understanding annual reports published by publicly-held hospitality firms. Part I in the Spring 1988 issue established the informational content of such reports while this article will focus on the examination and understanding of annual reports, suggested guidelines on how to use them for decision making, and recent developments affecting these reports.

Keywords

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Understanding Annual Reports Of Hospitality Firms: Part II

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This is the second article in a two-part series on understanding annual reports published by publicly-held hospitality firms. Part I in the Spring 1988 issue established the informational content of such reports while this article will focus on the examination and understanding of annual reports, suggested guidelines on how to use them for decision making, and recent developments affecting these reports.

A variety of economic developments are exacting their tolls on hospitality firms' performance in unpredictable ways. The stock market crash of 1987, the increasing number of corporate restructurings, overbuilding, the recent congressional hearings, the impact of the Tax Reform Act of 1986, among other major forces, are heightening concern about corporate accountability. Now more than ever investors, creditors, owners, employees, and other users of financial information are demanding increased information that will enable them to evaluate how the hospitality enterprise will cope with a rapidly-changing business environment and, thus, calling upon hospitality management to account for its action.

Indeed, recent economic developments have refocused attention on annual reports as a major tool in the decision-making process. Companies must seriously consider "enlisting the annual report as a natural way of getting investors to trust them."¹ After all, the annual report is the best platform a publicly-held firm has all year to explain future goals and strategies while remaining accountable for past actions.

Annual Reports Are Major Resource for Decision Makers

The annual report is an important medium through which information of both a qualitative and quantitative nature is transmitted to decision makers for their evaluation and action. Yet a number of research studies have suggested that investors as well as other intended users do not read annual reports or spend a minimal amount of time on them. Specific complaints about annual reports have included not credible, too technical, too promotional, and not dependable, "a place to radiate optimism, not recount failings."²

Nonetheless, "if the reader keeps that bias in mind, the annual report can serve as a primary source of information."³ If the reader learns

to read between the lines to ask appropriate questions and obtain pertinent responses, the annual report can become an essential resource for decision makers.

The report usually opens with a traditional message from the chairman of the board and/or president, followed by a review of major segments or divisions and what they are expecting to accomplish in the next year. Usually management's discussion and analysis will come next; the financial section comprised of financial statements, footnotes, and the independent auditor's report is included toward the end. Other sections might include a 10-year summary, financial highlights, etc.

Recent Developments Have Affected Annual Reports

Three developments are expected to have a major impact on annual reports: the simplified version, a new auditor's report, and a revised statement of cash flows.

The simplified annual report (SAR), which was approved by the Securities Exchange Commission in 1987, is based on a four-year study conducted by Deloitte, Haskins and Sells (in association with the Financial Executive Research Foundation). The SAR is "a condensed and less detailed version of the conventional annual report, thus more readable and understandable by individual readers."⁴ It effectively removes the four-color, glossy, traditional annual report from the SEC compliance system "by permitting the company to include full audited financial statements and other required financial disclosures on proxy material sent to all shareholders."⁵

In June 1987 McKesson Corp. issued the first SAR, resulting in a \$87,000 savings on the glossy report "from the \$250,000 it cost to produce a standard annual report in the preceding year."⁶ Accordingly, the financial community's reaction to the SAR has been, in general, "positive and encouraging."⁷ Some attorneys and accountants, however, are concerned that management may use this new simplified annual report in a way that conveys only good news and completely omits unfavorable results.

The auditing Standards Board recently issued SAS 58, "Reports on audited financial statement," mainly "to better public understanding of the auditor's role."⁸ SAS 58 is effective for reports issued and reissued on or after January 1, 1989. Yet earlier application is permitted. This new and improved auditor's report clarifies management and auditors' responsibilities for financial statements by establishing management's full responsibility for the company's financial statements and restricting the auditor's responsibility to the expression of an opinion on the fairness of financial statement presentation. It is through this new auditor's report "that the accounting profession aspires to eliminate the public's misunderstanding of the report and to communicate more precisely the roles that the auditor and management play."⁹

FASB Statement 95, "Statement of Cash Flows," requires all companies to include a statement of cash flows as part of the full set of financial statements, thereby replacing the previously required statement of changes in financial position. This pronouncement is effective for years ending after July 15, 1988, and focuses on changes in cash and cash equivalents, as opposed to changes in working capital.

Guidelines to Examine Annual Reports Are Useful

It has been established that the outside world is becoming more demanding in its need for critical information that will assist in the decision-making process. Accordingly, there is growing concern to make the information contained in annual reports more useful to potential users. The following guidelines outline the specific steps to be followed in examining annual reports:

•**Step 1:** As a starting point the reader looks at the letter from the president and/or chairman of the board to the shareholders which provides the reader with an overview of corporate progress and future goals while anticipating the business climate of the upcoming year. It is important to keep in mind that the president is trying to impress.

•**Step 2:** Read the independent auditor's report found toward the back of the annual report. The main concern here is to determine whether the independent auditor has issued an unqualified (or clean) opinion on the financial statements. Anything else is a warning that something might be wrong.

•**Step 3:** Next we examine the financial statements starting with the balance sheet followed by the income statement and the statement of changes in financial position (or newly-revised statement of cash flows).

•**Step 4:** Read notes to the financial statements (or footnotes) in order to acquire a better understanding and clarification of the information contained in the three basic financial statements.

•**Step 5:** Review management's discussion and analysis section. This will explain their version of underlying causes and economic influences affecting changes in revenues, expenses, and net income while focusing attention on matters that are expected to impact future operations.

•**Step 6:** Examine financial highlights and other available information. List questions to be answered in annual meetings or by outside sources.

Before completing the aforementioned review, it becomes appropriate that the reader acquire a good understanding of the informational content of annual reports. (See Part I of this article in the Spring 1988 issue). Additionally, a thorough understanding of the hospitality industry environment is essential. In order to provide an insight into the examination of the annual report of an actual firm in the hospitality industry, an examination of the annual report of La Quinta Motor Inns, Inc. for 1988 will be undertaken. A brief overview of the company is presented followed by the six-step guidelines.

La Quinta Motor Inns, Inc. Provides Case Study

La Quinta Motor Inns, Inc. had been among the fastest-growing lodging chains since it was founded in 1968. It has been involved in the development, ownership, operation, or licensing of motor inns, mainly in the Southwest, South, or Midwest, primarily serving the needs of the frequent business traveler. La Quinta had been strategically and successfully positioned between budget and luxury hotels.

La Quinta's number of rooms roughly doubled during the five years ended May 31, 1983. However, the company was adversely affected by the 1982-1983 recession. According to Sam Barshop, president and chairman of the board, 1983 was a challenging year for La Quinta. Barshop stated "our management faced perhaps the most difficult time in our corporate history." For the first time the economic downturn spread to La Quinta's major market area, the Southwest.

In recent years, La Quinta has continued facing difficulties due to economic downturns in energy related economies. Accordingly, the occupancy levels of 80-90 percent achieved in the late '70s and early '80s (with return on equity well over 20 percent) have been steadily decreasing to 60.4 percent (fiscal 1987) and 61.3 percent (fiscal 1988) with return on shareholder's equity of 3.5 percent (1987) and 2.7 percent (1988).

In response to the economic difficulties, La Quinta has focused on expansion into a variety of geographic areas such as California, Florida, and other southeastern states in order to decrease the risk associated with dependence on one economic area.

An examination of La Quinta's annual report for the year ending May 31, 1988, shows the following:

•**Step 1:** The starting point is a letter to shareholders signed by Sam Barshop, president and chairman of the board; attention is focused on inquiries to be made concerning La Quinta's progress and future goals.

• What are the major challenges and opportunities facing the company and how does the management plan to respond? According to Barshop, La Quinta's basic concept of "consistently delivering a clean, comfortable room with excellent guest service has not changed"¹¹ in its first 20 years, although La Quinta "has modified the presentation of its product slightly as consumer demands changed."¹² Barshop acknowledges that La Quinta has been experiencing very difficult times during the "past three challenging years."¹³ Nonetheless, he believes that the company "is well positioned to benefit from improvements to its major market area economy, in Texas, stemming from increased tourism.

• How have the changes in oil prices affected La Quinta? How will the company be affected by future fluctuations in oil prices? Management believes that "because 40 percent of our rooms are in Texas, the economies of Texas and the contiguous states will continue to significantly impact the company. The oil and gas industry is still a significant part of the Texas economy, but there has been diversification into other industries such as electronics, bio-medical technologies and tourism."¹⁴ Moreover, since La Quinta now has properties in California, the Midwest, Florida, and other southeastern states, the company will not be so badly affected by future fluctuations in oil prices, as these states are not energy related economies.

• What steps has the company taken to improve productivity and quality control to gain a competitive edge? La Quinta's management team has full control of the operating policies of the inns, whether owned or managed. They consider this to be their strongest competitive edge since the company can exercise complete quality control over product and service.

“Management believes it is necessary to renovate each property every five to six years for two reasons: First, changing styles and consumers’ tastes necessitate redecoration and, second, renovating helps us maintain the high quality standards of our properties.”¹⁵ Second, management feels that “maintaining our competitiveness in the labor market will continue to be a challenge in the coming years.”¹⁶ This will be done by increasing professional employee training and extending employee benefits to most inn employees.

- **Step 2:** After the reader has acquired a general picture of corporate progress and received an overview of the business climate for the upcoming year, attention is turned to the independent auditor’s report (CPA’s opinion letter).

- Did the independent auditor issue an unqualified opinion on the company’s financial statements? Independent auditors are “reasonably sure” that the financial statements of La Quinta present fairly the financial position of La Quinta at May 31, 1988 and 1987 and the results of its operations and changes in financial position for each of the years in the three-year period ended May 31, 1988, in conformity with generally acceptable accounting principles.”¹⁷ As a result, the reader can feel confident that the statements accurately represent what they purport to.

- Who is the firm that audits the company? Peat Marwick Main & Co. (San Antonio, Texas, office) issued the independent auditor’s report on July 22, 1988. This well recognized, big-eight CPA firm has been auditing La Quinta’s financial statements for many years. Accordingly, the audit performed by Peat Marwick as a basis to express its opinion on the fairness of presentation of La Quinta’s financial statements serves to enhance the user’s confidence that these statements do not contain material misstatements. That is because the auditing firm is independent, objective, and knowledgeable of the entity’s business and financial reporting requirements.

- Did the firm adopt the newly-revised auditor’s report? Are the auditor’s and management’s responsibilities clearly established? Although La Quinta was not required to include the revised auditor’s report until after January 1, 1989, the new format was used. Accordingly, the auditor’s report included an introductory paragraph that clearly indicated that La Quinta’s management was solely responsible for the contents of all financial statements. Likewise, the auditor’s responsibility was restricted to the expression of an opinion on those statements.

- **Step 3:** Financial statements are next examined commencing with the balance sheet.

Balance Sheet Review: Investors, creditors, and other financial statement users have long recognized the value of a balance sheet that helps them understand the financial condition of a corporation. This information is particularly useful “during times of prolonged recession and inflation when corporate’s cash flows are squeezed and a company’s success may be as much a function of its liquidity and solvency as of its profitability.”¹⁸

Major features concerning the review of La Quinta's combined balance sheet as of May 31, 1988, are highlighted with comparative figures as of May 31, 1987.

- The financial information is presented for two years (1988 and 1987) in order to facilitate the comparison to the previous year.

- The statements contain the designation "La Quinta Inns, Inc. Combined Balance Sheets." The term "combined" indicates that La Quinta owns other smaller corporations (subsidiaries) and unincorporated ventures (joint ventures) in which the company has interest and exercises legal, financial, and operational control.

- Cash and short term investments (\$41 million in fiscal 1988 and \$37.7 million in fiscal 1987) is the most significant current asset shown on La Quinta's balance sheet. A substantial portion of this balance will be used to meet future costs of specific motor inns during construction. "Funds in hand, committed and anticipated from cash flow from operations, are sufficient to complete construction projects."¹⁹

- As is the normal situation for most lodging chains, La Quinta has a substantial investment in land, buildings, and equipment. However, its decision to sell some of its properties, "a significant departure from La Quinta's historical desire to own a large percentage of its inns,"²⁰ has resulted in a decrease in net property and equipment from \$493.4 million in 1987 to \$465.5 million in 1988. Substantially all property and equipment has been pledged as collateral for borrowings.

- "Inns under development" shows a marked decrease in fiscal 1988, serving as evidence of the continuous slow down in the La Quinta's growth. Only seven inns were added to the system in fiscal 1988.

- The significance of long-term debt demonstrates the high use of debt financing (financial leverage) in relation to equity financing. The long term debt instruments are mostly mortgage loans and industrial development revenue bonds maturing from 1988 to 2012. The high use of debt financing reflects the high risk of La Quinta's long term debt-paying ability in relation to other hospitality firms.

- The shareholders' equity decrease from \$117.9 million (1987) to \$111.4 million (1988) is mainly attributable to the increase in treasury stock by almost \$10 million in 1988. La Quinta repurchased 861,000 of its outstanding common shares between October 23, 1987, and January 27, 1988, following the stock crash of October 1987. This financial strategy "was consistent with the company's long standing policy to repurchase its own stock when it was prudent to do so."²¹

Income Statement Review: In reviewing the income statement (or statement of earnings), most concern is with the ability of management to generate sales revenue, control expenses, and thereby earn a profit for La Quinta's shareholders. Some observations concerning La Quinta's Statement of Earnings follow.

- The combined statement of earnings of La Quinta is presented in comparative form for the years ending May 31, 1988, 1987, and 1986. In

contrast to the balance sheet, three years of comparative data are required.

- Because of concentrating on the sale of rooms, La Quinta's most significant source of revenue and operating expenses is, by far, from motor inns. Restaurant rentals and other revenues are mainly related to the leasing of restaurants adjacent to La Quinta Motor Inns to several restaurant chains.

- Management services revenue showed a dramatic increase over the three-year period ending May 31, 1988. In contrast, there was a decreasing trend in inn revenues. This is consistent with La Quinta's financial and strategic plan of retaining management control of all the inns sold in the past two years while "decreasing ownership in inns to 50 to 60 percent of its rooms as a current preferred level of ownership."²²

- The gain on sale of assets was \$9.9 million in 1987 and \$10.5 million in 1988. No inns were sold in fiscal 1986. The 1988 gain stemmed primarily from the sale of inns to Cigna joint ventures while the 1987 gain related to the sale of 31 inns to LQM Operating Partners L.P., a publicly-traded master limited partnership. These non-recurring gains positively impacted the bottom line of La Quinta, thereby producing net earnings in the presence of operating losses in both 1987 and 1988.

- Earnings per share has been steadily decreasing from 41 cents per share in 1986 to 30 cents per share in 1987 to 24 cents per share in 1988 in spite of a decrease in the weighted average number of common shares outstanding (due to the purchase of treasury stock).

The review of the statement of earnings reveals that La Quinta has been experiencing major drawbacks. First, net income and earnings per share declined in spite of a reduction of the number of shares outstanding. Second, a slight decline in revenues was accompanied by an increasing trend in expenses, especially direct costs, thereby producing a decline in profit margins. Third, there was a significant impact on net earnings resulting from non-recurring items--gain on sale of assets. Taking these factors into account one can conclude that La Quinta's operating performance has been rather poor.

Changes In Financial Position Review: Since La Quinta's 1988 annual report included years ending before July 15, 1988, the company is still using the statement of changes in financial position which focuses on changes in working capital for the three-year period ending May 31, 1988. Some review comments follow:

- The combined statement of changes in financial position reveals that La Quinta's ability to receive working capital internally from operation has been steadily declining. This was the result of the decrease in net earnings after adjustments for non-cash charges (credits) to operations, especially the net gains from property transactions reported in 1987 and 1988.

- No dividends were paid by La Quinta during the three-year period ending May 31, 1988. As a result, earnings are being reinvested for expansion purposes.

- In 1986 working capital used for capital expenditures was quite substantial, \$116.7 million. To finance this aggressive expansion the company used working capital from operations and long-term borrowings. But the total uses were higher than the total working capital received during that year, thereby producing a \$7.4 million decrease in working capital. Conversely, in 1987 the reduction of capital expenditures to \$76.7 million accompanied by major proceeds from the sale of 31 inns to the master limited partnership, resulted in an increase in working capital of \$22.5 million. In fiscal 1988 a slight decrease in working capital of \$576,000 occurred in spite of the reduction of capital expenditures to \$37 million and the proceeds received from property transactions in the amount of \$51.6 million. This was attributable to the reduction in working capital from operations, lower long-term debt borrowings, and the purchase of treasury stock.

- **Step 4:** The notes to La Quinta's financial statements amplify and clarify the information contained in the three basic financial statements. Specific review questions addressing accounting policies, commitments, contingencies, and income taxes follow:

- Does the company follow accounting practices most prevalent in the industry? Are they liberal or conservative? La Quinta follows the accounting practices most prevalent for publicly-held hospitality companies. They are generally liberal, thereby resulting in higher reported net earnings (e.g., "note 1"²³ to La Quinta's financial statements—straight line depreciation, earnings per share and others).

- Are there any major restrictions concerning long term agreements? Do you expect any problems in complying with debt covenants? Based on the terms of a credit line and other loan agreements, the company is precluded (among other things) to pay cash dividends, mergers, sales of substantial assets, incurrence of significant lease obligations, and any material change in the character of the business. It was stated that "the company is in compliance with or had obtained waivers for all such covenants as of May 31, 1988."²⁴ It was further noted that "the company is currently negotiating the extension of its line of credit (\$30 million) with participating banks."²⁵

- Is any litigation pending or threatened? Although the company is a party to various lawsuits and claims generally incident to its business, "the ultimate disposition of these matters is not expected to have a significant adverse effect on the company's financial position."²⁶

- Why is the effective income tax rate so much different than the 34 percent statutory rate? Is the company taking advantage of income tax credits? La Quinta's effective tax rate was lower than the statutory rates in 1988, 1987, and 1986 (especially in 1988). This was mainly attributable to lower capital gains rates associated with property sales and taking advantage of tax credits (e.g., targeted jobs tax credit, historical tax credit, and investment tax credit). Accordingly, La Quinta's lower effective tax rates had a positive impact on the company's bottom line.

• **Step 5:** A careful evaluation of management's attempt to reconcile underlying causes and economic influences affecting the company's operating performance, financial condition, and capital resources greatly enhances the understanding of annual reports. For several years, publicly held companies have been required to include in the annual reports data "not otherwise reported and to provide interpretation and clarification in narrative form"²⁷ under management's discussion and analysis. There are certain material events that could have an impact on future operations which must be focused upon to gain some perspective:

• How is revenue derived for the company? What are the major factors accounting for changes in revenue? The three sources of revenue for La Quinta are inn revenue, restaurant rentals, and other management services. The decrease in inn revenue during 1988 was attributable in part to the sale of inns which resulted in fewer rooms available for sale, to the lower average daily rate due to discounting (in areas of weak demand) and the economic conditions in Texas and adjacent states. "According to La Quinta's management a trend in positive year-to-year occupancy comparisons began in the first quarter of 1988 and continued through the remainder of the fiscal year."²⁸

• Why did operating costs and expenses increase in spite of the decrease in revenue, that is, a decline in operating margins? According to management, the increase in direct expenses in fiscal 1988 "was due in part to the company's accelerated maintenance and remodeling program."²⁹ Management also noted that "depreciation increased marginally in 1988 compared to higher increases in previous years." This was the result of "year-to-year increases in depreciation being affected by the costs of new inns and the number of inns opened during the year."³⁰

• What has been the impact of inflation on the operating performance of the company? "The rate of inflation as measured by changes in the consumer price index has not had a material effect on the revenue or net earnings of the company"³¹ in the three-year period ending May 31, 1988.

• What are the company's expectations for revenue, expenses and net earnings? What changes are anticipated in the future? Management believes that positive occupancy comparisons will continue through fiscal 1989. Yet it recognizes that "the overall occupancy level in 1989 will be dependent upon economic changes in the company's major markets and the effect of new and existing competition."³²

However, "in fiscal 1989 an increased level of benefits to inns employees will substantially offset lower costs associated with the company's maintenance and remodeling program,"³³ thereby increasing direct expenses.

• **Step 6:** Once the review of all financial and operating data is completed, other sections of the annual report can be reviewed. For instance, financial highlights for 1987 and 1988, which were included on the first

page of La Quinta's annual report, serve to reinforce the company's decline in operating performance. Revenues, operating income, net earnings, earnings per share, and return on equity went down in 1988. The only positive statistic was the slight increase in occupancy percentage to 61.3 percent (still below industry standards.)

The five-year summary of selected financial and statistical data included later on in the annual report further indicates a gloomy picture. It highlights the steady decrease in return on equity from 12.7 percent in 1983 to 2.7 percent in 1988. It is interesting to note that a 10-year summary was not included since it would further reveal the marked decline in La Quinta's operating performance as compared to earlier years.

The examination of La Quinta's 1988 annual report has left some open questions concerning a wide range of potential issues. In fact, Ed Tavlin, a well-known financial analyst, contends that "information that is not in the annual report may just be as important as information that is."³⁴ Tavlin further notes that "when doing research on a company the annual report nearly always leaves him thirsting for more knowledge."³⁵

The following are typical of questions that are worth exploring by reviewing external sources or by attending the company's annual meeting:

- What is being done to improve margins, e.g., reduce costs?
- How does the company's return on investment compare with others in the industry?
- How did actual results compare with forecasted amounts?
- What will the company's pricing strategy be in the presence of increasing inflation?
- What effect will changes in the current level of interest rates have on earnings? On liquidity?
- Are there any provisions of the Tax Reform Act of 1986 or subsequent amendments that will affect the company in 1989 or 1990?
- What is the current status of the Internal Revenue Service tax examinations? Are there any deficiencies involved?
- What factors exist that might make the company an attractive takeover candidate?
- Does the company plan public offerings of stock or debt?
- Was the company successful in negotiating an extension on its line of credit?
- How does the company's price earnings ratio compare with others in the industry?
- How is management working to maximize shareholder value in the long and short term?

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