1983

# Updated illustrations of management's discussion and analysis of financial condition and results of operations : a survey of the application of recently amended Rules 14a-3 and14c-3 of the Securities and Exchange Act of 1934 in annual reports to shareholders; Financial report survey, 26

Hortense Goodman

Leonard Lorensen

FINANCIAL REPORT SURVEY 26

# Updated Illustrations of Management's Discussion and Analysis of Financial Condition and Results of Operations

**A survey of the application of recently amended Rules 14a-3 and 14c-3 of the Securities and Exchange Act of 1934 in annual reports to shareholders**

by Hortense Goodman, CPA
and
Leonard Lorensen, CPA

AICPA
American Institute of Certified Public Accountants

Updated Illustrations of Management's Discussion and Analysis of Financial Condition and Results of Operations

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## FINANCIAL REPORT SURVEYS

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*A survey of applications of APB Opinion No. 22*

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# Updated Illustrations of Management's Discussion and Analysis of Financial Condition and Results of Operations

***A survey of the application of recently amended Rules 14a-3 and 14c-3 of the Securities and Exchange Act of 1934 in annual reports to shareholders***

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

## NOTICE TO READERS

This is a publication of the staff of the American Institute of Certified Public Accountants and is not to be regarded as an official pronouncement of the Institute.

# PREFACE

This publication is the twenty-sixth in a series produced by the Institute's staff through use of the Institute's National Automated Accounting Research System (NAARS). Earlier publications in the series are listed on the inside cover of this publication.

The purpose of the series is to provide interested readers with examples of the application of technical pronouncements. It is believed that those who are confronted with problems in the application of pronouncements can benefit from seeing how others apply them in practice.

It is the intention to publish periodically similar compilations of information of current interest dealing with aspects of financial reporting.

The examples presented were selected from over eight thousand annual reports stored in the NAARS computer data base.

This compilation presents only a limited number of examples and is not intended to encompass all aspects of the application of the pronouncements covered in this survey. Individuals with special application problems not illustrated in the survey may arrange for special computer searches of the NAARS data banks by contacting the Institute.

The views expressed are solely those of the staff.

George Dick
Director, Technical Information Division

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## SCOPE AND PURPOSE OF THE SURVEY

### DESCRIPTION OF THE RULES

Since 1974 companies registered with the U.S. Securities and Exchange Commission have been required under Rules 14a-3 and 14c-3 of Regulations 14A and 14C of the Exchange Act to present in annual reports issued to stockholders a section titled "Management's Discussion and Analysis of the Summary of Operations." (Financial Report Survey 6, "Illustrations of the Summary of Operations and Related Management Discussion and Analysis," published by the AICPA in 1975, presented illustrations of this section). Rules 14a-3 and 14c-3 were subsequently amended by Securities Act Release No. 17114, issued on September 2, 1980, which eliminates the summary of the results of operations required under the old rules and specifies in a more detailed manner the nature of the information to be presented in the section. The title of the section under the new rules is "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The management discussion and analysis section in annual reports to stockholders duplicates the management discussion and analysis section in annual reports filed with the SEC (Item 7 of Form 10-K) under Item 11 of Regulation S-K. Additional instructions for preparing the section are contained in the SEC "Codification of Financial Reporting Policies," section 501.

Excerpts from Release No. 17114, and Section 501 of the Codification, are reproduced as appendices to this survey.

### SOURCE OF ILLUSTRATIONS

The preparation of a management discussion and analysis of financial condition and results of operations in accordance with the new Rules 14a-3 and 14c-3 requires considerable judgment. An accountant who is confronted with problems in applying the Rules can benefit from learning how other accountants are applying them in practice. Accordingly, this publication presents excerpts from recently published annual reports that illustrate their application. Pictorial diagrams are omitted.

The AICPA National Automated Accounting Research System (NAARS) was used to compile the information. The 46 examples presented were selected from the management discussion and analysis sections of more than 8,000 published annual reports to shareholders stored in the computer data base.

# II

## RESULTS OF OPERATIONS

The new Rules 14a-3 and 14c-3 require two topics to be included in the management discussion and analysis section of an annual report: results of operations and financial condition. The discussion of the results of operations principally involves explaining the nature of and changes in the various revenues, expenses, gains, and losses reported in the income statement.

The companies surveyed for this publication classified the discussion of the results of operations by business segment, year of operation, or some other basis. Fourteen examples are presented below of those three types of classification. One company used two types of classification.

### BUSINESS SEGMENT

ACF INDUSTRIES, INC.
*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Operating Results

Results for each of the three years 1979 through 1981 reflect the benefits of the contracyclical nature of the Company's various manufacturing operations, and the earnings stability provided by its non-manufacturing segments. The substantial decline in revenues and profitability of the rail car manufacturing operations in 1981 was softened by gains in other manufacturing segments, particularly in the valves and related products operations. This was in contrast to 1980 when the severely depressed markets for automotive products and the flat industrial plastics operations were covered by gains in rail car manufacturing and valves and related products. In each year 1979 through 1981, results of the non-manufacturing operations (railroad freight car leasing and gas and oil) have shown very satisfactory increases in both revenues and profitability.

Valves and Related Products

The valves and related products operations have grown substantially over the last three years. This growth reflects the active oilfield equipment market in general, and, more importantly, the Company's ability to respond to this market by broadening its product base and increasing its production capacity through capital expansion and productivity improvement programs. Over the three-year period 1979 through 1981, revenues from valves and related products have grown at a compound annual rate of 25%. More significant, however, is the growth in profitability of this segment. Return on sales (income before taxes as a percent of total revenues) increased from 13% in 1979 to 23% in 1981;

and return on investment (income before taxes as a percent of total assets) has improved from 15% to 29%. These gains are the combined result of higher selling prices, shifts in product mix toward higher pressure equipment and wellhead components, and substantial productivity improvements in the manufacturing operations.

The Company believes the growth in markets for valves and related products will continue in 1982 and beyond and, as discussed under "Liquidity and Sources of Capital," has committed over 50% of the total 1982 plant facilities capital budget to expanding and improving these operations.

### Railroad Freight Car Leasing

Revenues from leasing operations have grown steadily at about 10% per year for the past three years. This growth has been due to the increase in the size of the lease fleet, a high utilization rate (over 97%) of the lease fleet, and the ability to renew expiring leases at favorable rates. Income before taxes in 1981 also showed strong improvement, in spite of a substantial increase in interest costs on new borrowings to finance fleet additions and a four-month strike which closed three of Shippers' repair facilities. The increase in income before taxes from 1979 to 1980 included a $10.3 million reduction in depreciation expense which resulted from a change in the estimated useful life of a majority of cars in the lease fleet from 20 to 25 years, and an increase in their residual value to reflect past experience and industry practice.

### Industrial Plastics

Industrial plastics revenues increased by 7% in 1981, after a relatively flat year in 1980 coming off a record year in 1979. Growth in the major product lines sold in domestic markets was very strong in 1981. Revenues from coating powder sales have grown steadily over the last three years. Sales of shapes and parts, which were adversely affected in 1980 by depressed economic conditions in the U.S. and declined by approximately 3% from the 1979 level, rebounded sharply in 1981 with a 21% increase. The rebound in the shapes and parts business and the continuing growth in the coating powder lines improved the 1981 income before taxes of the domestic operations to a record level. The foregoing gains, however, were offset by declines in revenues and income before taxes of the European operations, caused by the economic slow-down which began in Europe in 1980 and worsened in 1981.

### Gas and Oil Operations

Revenues from gas and oil operations increased 35% in 1981 over 1980. Higher gas and oil prices were the major factor in 1981's revenue growth, as the rate of production grew by only 4%. Profitability of the gas and oil operations in 1981, however, did not keep pace with the revenue growth. This was primarily the result of increased amortization expense and higher windfall profit taxes.

### Automotive Fuel System Components

Revenues from automotive fuel system components manufacturing improved 10% in 1981 over very depressed levels in 1980. This gain took place during a period of severely depressed markets for new car and truck sales, and reflects the Company's increased emphasis on aftermarket and remanufactured products. Contributions of replacement parts sales to total revenues for this segment increased from approximately 35% in 1979 to greater than 50% in 1981. Continued growth is expected in this area as many consumers are choosing to repair and maintain older cars rather than buy new ones.

During 1980, the Company took two significant actions affecting the future of its automotive segment. Early in the year, the Company formed a joint venture, Carter-Weber, Inc., with Weber S.p.A., to produce carburetors for small engines by selling to Weber a 50% interest in two existing Carter Automotive Division plants. Included in the automotive segment's loss from manufacturing operations before taxes is the Company's equity in net losses of Carter-Weber of $3.5 million in 1981 and $1.5 million in 1980. Results for Carter-Weber since formation have been adversely affected by the depressed new car and truck markets and by start-up costs associated with the introduction of new carburetors for four cylinder engines. Results for 1982 and beyond are expected to benefit from this effort.

Also, in 1981 the Company announced the phasing out of carburetor manufacturing at two remaining plants and provided $28 million in its 1980 accounts for the estimated costs associated with this decision.

Railroad Freight Car Manufacturing

Revenues from railroad car manufacturing declined 40% in 1981, resulting in a loss before taxes of $7.5 million. The primary reasons for this decline were the strike which closed two carbuilding plants for four months, and the declining markets for products manufactured at the third plant. Freight and tank car deliveries were 6,540 in 1981, 12,725 in 1980, and 11,172 in 1979. The low demand for new freight cars experienced in 1981 will continue to adversely affect this segment's operations during 1982.

CERTAINTEED CORPORATION

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Results of Operations by Segment

Building Materials

Net sales in 1981 declined 4% from 1980, however, shipping volumes were down nearly 10%.

The volume decline reflects 1981's substantial reduction in housing starts from 1980 and lower remodeling activity caused by record-high interest rates. Margins and earnings were sharply lower in 1981, particularly for roofing products, due to lower volumes and rising raw material and energy costs that could not be recovered through pricing actions due to extremely competitive market conditions. During 1981, the East St. Louis, Ill. roofing felt manufacturing facility was closed permanently. In addition, roofing operations were halted temporarily at York, Pa. and Kansas City, Mo. due to softening market conditions.

Net sales in 1980 for the Building Materials segment declined 15% from 1979, predominantly due to a decline in roofing tonnage. The sales decline reflected 1980's lower level of housing construction and remodeling activity,

Roofing margins were lowered substantially by cost increases, particularly for asphalt and energy, unrecovered through increased selling prices.

Fiber Glass Products

Net sales increased approximately 16% in 1981. Both shipping volumes and particularly selling prices increased in 1981. Volumes rose for residential and industrial insulating applications but were lower for automotive applications. Reinforcement shipments were up sharply in 1981 aided by the April start-up of a third furnace. Reinforcement demand, however, has not been sufficient to support operation of all four furnaces at our Wichita Falls facility.

Operating profit in 1981 was up sharply from 1980 due to increased selling prices, improved manufacturing efficiencies and higher capacity utilization.

Net sales in 1980 increased 11% from 1979 due to pricing actions and increased volumes for residential products. The 1980 shipments benefited by a full year's contribution of a new West Coast insulation production facility and a new insulation product, Insul-Safe® II . . . both began full-scale operations in mid-1979. In 1980, product demand supported operations at 50% of capacity at our Wichita Falls reinforcement facility.

Piping Products

Net sales in 1981 declined nearly 4% due mainly to a decrease in net selling prices for PVC piping products and reduced outside sales of PVC resin. The lower net selling price for PVC pipe reflects both the reduction in PVC resin and monomer costs, the principal raw material for producing this product, and competitive conditions. Profit margins in 1981 also were lower due to reduced A/C pipe volumes and lower selling prices for PVC pipe. During 1981, the Ambler, Pa. A/C pipe manufacturing facility was closed permanently due to insufficient demand levels in its shipping area.

Physical volumes in 1980 declined by 15% from 1979 with A/C piping products registering a greater reduction than PVC piping products. The decline for both product lines was attributable to a general slowdown in construction activity.

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MEREDITH CORPORATION
*Management's Discussion and Analysis of Results of Operations and Financial Condition*

Results of Operations

Fiscal 1981 revenues reached $403.4 million, an increase of $54.4 million. Revenues from operations were up $30.9 million in 1980 and $31.3 million in the preceding year. Earnings also increased each year: $4.2 million in 1981 (before the extraordinary item), $5.1 million in 1980 and $1.8 million in 1979. Profit improvements in the Book Publishing and Broadcasting segments were the most significant.

*Magazine Publishing and Printing.* The fiscal 1981 revenue increase reflects 11 additional issues of *Sail* magazine, purchased by a subsidiary in May 1980, and higher printing revenues from external publications. Amortization costs associated with the acquired subscription list of *Sail* magazine and the transition of *Apartment Life* to *Metropolitan Home* have been major factors in offsetting the revenue gain. Incremental promotion costs were incurred in positioning *Metropolitan Home*, along with higher-quality paper and upgraded processing procedures in the magazine's production.

The number of Special Interest Publication titles issued has increased over the past three years. Subscription, newsstand cover and advertising rate increases were implemented in response to the higher unit costs of magazine paper, processing and delivery. *Better Homes and Gardens* ad pages declined during the interval.

*Broadcasting.* Significantly higher commercial time sales to television advertisers, local and national, resulted in the fiscal 1981 operating profit increase. All television stations generated revenue gains. Radio operations recorded an overall increase in commercial time sales. However, higher radio programming and sales-related costs more than offset sales increases for the year. The current to prior period comparisons of radio operating results improved as the year progressed.

The three-year period 1979-1981 reflected substantial television revenue, profit and margin improvements despite much higher programming costs. WPGH-TV accounted for a disproportionate share of the programming cost increases, due to on-going efforts to improve the market position of the station, which was acquired in 1979. Although the trend appears now to be reversing, overall radio profits declined during the three-year period.

*Book Publishing.* Mail order and book club sales volume increases resulted in the higher profit level achieved in fiscal 1981. Profits also reflect a lower cost of manufacturing ratio due to volume-related benefits.

Following the decline in fiscal 1979 operating profits, changes in marketing books by mail resulted in significantly more productive promotion efforts. Profits in 1980 and 1981 reflect the improved response rates. Trade revenues have benefited from volume increases in the sales of books to national retail chain stores.

*Allied Products and Services.* Although 1981 revenues fell short of the prior-year level, operating results improved following the discontinuation of an experimental business, *Better Homes and Gardens* Craft Creations, during fiscal 1980.

*Better Homes and Gardens* Real Estate Service continues to incur costs of development activities and of servicing an expanding membership. Revenues, although steadily increasing, have not kept pace with the higher costs. Fees based on residential sales commissions of member firms have been influenced by the depressed residential real estate market.

*Other.* Interest income during the past two fiscal years has been greater due to a higher level of investment and more favorable interest rates.

Additional investment tax credit has resulted in the Company's declining effective tax rate (federal and state combined) during the last three years.

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R. J. REYNOLDS INDUSTRIES, INC.
*Management's Discussion and Analysis*

Results of Operations

Consolidated Sales and Earnings

Consolidated net sales and revenues in 1981 increased 13 percent to $11.69 billion, reflecting improved sales in all of the Company's lines of business. Earnings from operations rose 19 percent in 1981 to $1.50 billion, due principally to strong performances in the domestic tobacco and energy businesses, as well as improvements in all of the Company's remaining businesses.

Net earnings in 1981 increased 15 percent, to $768 million, while net earnings per fully diluted common share rose 91 cents to $7.03. The 1981 improvement in net earnings was achieved even though the Company had significantly lower levels of investment tax credits in 1981. This factor accounted for about 35 cents per share less in 1981 when compared with the previous year. The year-to-year comparison is also affected by a nonrecurring loss of 13 cents per share included in the 1980 results, which are discussed below.

Net sales and revenues in 1980 were $10.35 billion, an increase of 16 percent over the prior year. The 1980 consolidated results of operations included the first full-year results of Del Monte Corporation, acquired on February 2, 1979. Earnings from operations in 1980 were $1.27 billion, an increase of $183 million, or 17 percent, over the prior year.

Net earnings in 1980 increased $120 million, or 22 percent, while net earnings per common share rose $1.07 to $6.12 in spite of the effects of a nonrecurring loss of 13 cents per share related to a write-down of certain containerships in the Company's transportation business. (See Note 3 to the Financial Statements.)

In addition, net earnings in 1980 included the favorable effects of higher investment tax credits, primarily related to new diesel-powered containerships in the Company's transportation business, and the effect of capitalizing certain interest costs, mandated for the first time in 1980 by the Financial Accounting Standards Board. The contribution of both factors to the 1980 increase was approximately 66 cents per share. When compared with the previous year, these favorable factors were offset to some extent by a nonrecurring gain of 11 cents per share included in the 1979 results relating to the sale of the aluminum casting and rolling business in Huntingdon, Tennessee. (See Note 3 to the Financial Statements.)

Over the past five years, net sales and revenues increased at an annual compound rate of 15 percent, earnings from operations increased by 14 percent a year, and net earnings grew at a rate of 17 percent annually.

The percentage contributions of the Company's various lines of business to net sales and revenues and earnings from operations during the last five years were as follows:

Net Sales and Revenues

| | 1981 | 1980 | 1979 | 1978 | 1977 |
|---|---|---|---|---|---|
| Domestic tobacco | 33% | 34% | 35% | 43% | 42% |
| International tobacco | 18 | 20 | 21 | 23 | 21 |
| Foods and beverages | 20 | 20 | 20 | 4 | 4 |
| Transportation | 14 | 13 | 14 | 16 | 15 |
| Energy | 12 | 9 | 7 | 11 | 15 |
| Other businesses | 3 | 4 | 3 | 3 | 3 |
| | 100% | 100% | 100% | 100% | 100% |

Earnings from Operations

| | 1981 | 1980 | 1979 | 1978 | 1977 |
|---|---|---|---|---|---|
| Domestic tobacco | 58% | 60% | 63% | 68% | 71% |
| International tobacco | 11 | 13 | 13 | 13 | 12 |
| Foods and beverages | 6 | 7 | 11 | 2 | 3 |
| Transportation | 7 | 5 | 5 | 13 | 10 |
| Energy | 16 | 14 | 6 | 2 | 2 |
| Other businesses | 2 | 1 | 2 | 2 | 2 |
| | 100% | 100% | 100% | 100% | 100% |

Effective January 1, 1981, operational responsibility for certain operations was transferred to a newly formed unit of the Company. (See "Other businesses" discussion on page 26 of this report.) Prior years' results have been restated to reflect this change.

Domestic Tobacco

R. J. Reynolds Tobacco Company operations include the manufacture and sale of tobacco products, principally cigarettes, in the United States.

Domestic tobacco sales were $3.97 billion in 1981, an increase of 13 percent over 1980. The sales increase was due to unit volume gains and higher selling prices. Unit volumes in 1981 were up 2.7

percent compared with the previous year, establishing a sales record of 207.2 billion units, and achieved a market share of 33.1 percent, up from 32.7 percent in 1980. This record reflects the continued strength of the company's cigarette brands, most notably a strong performance by the Camel brand family, and the introduction of More Lights 100s early in July 1981. During 1981, the company continued its leadership in the growing low "tar" cigarette category (0-15 milligrams), increasing its share by 10.6 percentage points, to 45.7 percent of this segment of the market.

Earnings from operations rose 14 percent in 1981 to $914 million. The increase was attributable to the unit volume gains and higher selling prices noted above, which were more than sufficient to offset increased manufacturing costs and higher marketing and advertising expenses. Compared with a year ago, marketing and advertising expenses were about $104 million higher, principally as a result of aggressive advertising programs and the 1981 introduction of More Lights 100s previously noted. The 1981 earnings improvement also included a settlement of long-standing litigation, reported in the 1981 first quarter.

Domestic tobacco sales were $3.52 billion in 1980, an 11 percent improvement over 1979. The sales increase was due to higher selling prices and a 1.2 percent increase in unit volumes, which was achieved in spite of the adverse effects on 1980 volumes of stepped-up customer orders in late December 1979 in anticipation of a price increase. The unit volume increase reflected the strong performance of virtually all cigarette brands. Unit volume in the low "tar" cigarette category showed an 11 percent gain over 1979.

Earnings from operations in 1980 increased $86 million to $801 million. This increase was principally due to the higher selling prices and volume improvement noted above, which more than offset increased operating costs, and higher marketing and advertising expenses which were approximately $93 million above the prior year level. The higher marketing and advertising expenses were largely the result of an aggressive program to support the successful repositioning of the NOW brand family and the introduction during the year of NOW 100s, Salem Ultra, Salem Ultra 100s and Camel Lights Hard Pack.

### International Tobacco

R. J. Reynolds Tobacco International, Inc. manufactures and sells tobacco products in markets outside the United States. Products are currently manufactured in 25 countries by subsidiaries and licensees and are sold in more than 160 markets around the world. Sales include exports from the United States as well as products manufactured by foreign affiliates.

International tobacco sales in 1981 were $2.16 billion, an increase of 3.3 percent over the prior year. The sales increase reflected a 7.4 percent unit volume gain and higher selling prices, which were more than sufficient to offset the unfavorable effects of currency exchange rates in markets where sales are denominated in weakened foreign currencies. In translating foreign currency sales, unfavorable exchange rate movements, chiefly in Europe, reduced the company's U.S. dollar reported sales in 1981 by about $225 million.

Earnings from operations in 1981 were $178 million compared with $177 million in 1980. The marginal increase was due to the increased unit volumes and higher selling prices, and was achieved despite unfavorable foreign currency translation effects which totaled about $21 million.

International tobacco sales in 1980 were $2.09 billion, up 12 percent over 1979. Higher unit volume and selling price increases contributed about equally to the sales gain with unit volume and market share gains registered in most major markets of the world. Unit volume growth for the company as a whole, however, was somewhat below that of 1979 because of lower export shipments to the Middle East as a result of the political situation in Iran.

Earnings from operations in 1980 rose to $177 million, an increase of 19 percent over the prior year. The year-to-year gain was due primarily to higher unit volume and favorable pricing which more than compensated for inflationary cost increases.

### Foods and Beverages

Del Monte Corporation manufactures and sells food and beverage products domestically and internationally. Food products are distributed in about 60 countries and include Del Monte brand canned fruits and vegetables and fresh fruits, Hawaiian Punch beverages and drink mixes, Chun King Oriental-style foods and Patio Mexican frozen foods. In late February 1981, the company acquired Morton Frozen Foods (a division of ITT Continental Baking Company), whose principal operations include the manufacture of frozen prepared foods.

Food and beverage sales in 1981 were $2.33 billion, an increase of 11 percent over 1980. The principal factors in the sales gain were higher selling prices, particularly in U.S. grocery products, and volume contributions by Morton Frozen Foods.

Earnings from operations in 1981 rose 11 percent to $100 million. The increase was primarily due to the higher selling prices in domestic canned goods and LIFO inventory liquidation profits of $22 million (resulting from planned reductions of inventory levels), which were offset to a large extent by the impact of unfavorable currency exchange rates and expenses connected with the company's previously announced realignment of certain operations. Included in the 1980 results were two items (discussed below) which reduced earnings from operations in that year by approximately $17 million.

Food and beverage sales in 1980 were $2.11 billion, a 15 percent increase over 1979. The sales increase reflected the inclusion of Del Monte for the full 12 months of 1980 compared with only 11 months in 1979, as well as higher selling prices. Worldwide fresh fruit volume increased, while other food and beverage volumes combined were essentially unchanged from 1979 levels.

Earnings from operations in 1980 were $90 million, down 27 percent from 1979. The favorable pricing factors noted above were not sufficient for the company to recover higher costs for manufacturing, raw materials and marketing, particularly in domestic and European canned goods markets. Additionally, earnings from operations in 1980 were reduced by a $9.4 million provision for estimated expenses anticipated in connection with a planned consolidation and realignment of certain operations, and a $7.4 million charge for accrued vacation pay, resulting from the adoption of Statement of Financial Accounting Standards No. 43.

Food and beverage sales in 1979 were $1.83 billion, up from $281 million in 1978. Substantially all of the sales increase was due to the 1979 Del Monte merger. (See Note 17 to the Financial Statements.)

Earnings from operations in 1979 rose $105 million to $123 million. All of this gain was due to the merger previously noted, as earnings from operations in RJR Foods lines decreased as a result of higher manufacturing and marketing costs which could not be fully recovered through price increases. Earnings from operations in 1979 included an $11 million provision made during the fourth quarter for estimated expenses during the initial phases of integrating the Company's two foods operations.

### Transportation

Sea-Land Industries Investments, Inc. invests in containerized ocean freight transportation services, and its Sea-Land Service, Inc. subsidiary, one of the world's leading container shipping companies, operates a fleet of containerships serving 124 ports in more than 50 countries and territories.

Transportation revenues were $1.62 billion in 1981, a 15 percent improvement over the prior year. The revenue increase was largely due to higher shipping volumes in virtually all trade routes, with particularly strong gains in both the Pacific and North Atlantic trades.

Earnings from operations in 1981 increased 56 percent to $103 million. The higher earnings reflected the previously noted volume gains as well as productivity improvements and cost reduction programs. Earnings in 1981 also reflect a fourth quarter one-time charge of $10 million for settlement of certain litigation involving the ocean transportation of freight.

In August 1981, an agreement was reached with the U.S. Department of the Navy for sale of six of the company's eight SL-7 containerships and related equipment, together with an option for the Navy to purchase the remaining two vessels in 1982. The six containerships were subsequently sold in 1981 at their net book value. Under the terms of the agreement, the net proceeds from this sale will be deposited in a capital construction fund. (See Note 7 to the Financial Statements.) In the fourth quarter of 1980, the company wrote down the carrying cost of these assets to their estimated realizable value pending such sale. The write-down was not included in 1980 earnings from operations, but was reported separately as a "nonrecurring loss." (See Note 3 to the Financial Statements.) This sale is expected to have a favorable impact on the company's future operations since these vessels were not fuel-efficient. With the sale of the six SL-7 containerships, approximately 47 percent of the company's U.S.-flag fleet capacity is now comprised of modern diesel-powered containerships.

Transportation revenues increased 16 percent to $1.41 billion in 1980. This increase was principally due to higher shipping volumes, which accounted for more than one-half of the gain, and rate improvements along some trade routes. Overall cargo volumes in 1980 were favorably affected by gains associated with independent rate actions the company had taken in the eastbound transpacific trade after resigning from 12 shipping conferences late in the first quarter of 1980 and additional capacity provided by 12 new diesel-powered containerships, all of which were placed in service during 1980.

Earnings from operations rose 13 percent to $66 million in 1980. The higher earnings reflected the increased volumes, rate improvements, and improved productivity and cost controls. These factors were sufficient to offset increased operating costs, a large portion of which was due to vessel and terminal operating expenses.

### Energy

Aminoil USA, Inc. is primarily engaged in the exploration for and development, production and sale of crude oil and natural gas.

At year-end 1981, the company's principal domestic producing properties were located onshore and offshore California, Louisiana and Texas. The company is active in the major producing basins in the mid-continent and produces geothermal steam for electric power generation in California. Aminoil also has foreign operating interests in Argentina and the Dutch North Sea.

Energy sales in 1981 were $1.37 billion, up 39 percent from the previous year. The sales gain was principally the result of higher selling prices in all areas of the business, particularly for domestic crude oil, and higher petroleum product volumes.

Earnings from operations rose to $247 million in 1981, an increase of 35 percent from the prior year. The principal factors in the increase were the pricing gains and increased volumes noted above, which were more than sufficient to offset increased operating expenses and higher charges against earnings for depreciation, depletion and amortization. Earnings in 1981 included a favorable settlement of certain pricing issues, which arose in prior years, a gain on the sale of the company's liquefied petroleum gas retail marketing operations, and other adjustments, totaling $19 million. Increased production and higher prices from the company's geothermal steam operations also contributed to the 1981 earnings gain.

The favorable impact of the accelerated decontrol of domestic crude oil prices was offset to a large extent by increased "Windfall Profit" tax, which became effective March 1, 1980. The charge against earnings for this tax amounted to $123 million in 1981 compared with $34 million in 1980.

Energy sales were $985 million in 1980, an improvement of 57 percent when compared with 1979. The improvement was due primarily to higher prices for crude oil, natural gas, and natural gas liquids, which were associated with more favorable domestic energy regulations, as well as increased volumes of natural gas liquids and higher domestic natural gas and crude oil production.

Earnings from operations rose to $183 million in 1980, up sharply from $66 million in the previous year. The increase was due to the pricing gains and increased production noted above, which more than offset increased operating expenses and higher charges against earnings for exploration costs and for depreciation, depletion and amortization. In the fourth quarter of 1980, the company adopted the LIFO method of valuing certain natural gas product inventories which were previously valued using the average cost method. The change, which was made to more closely match current costs with current revenues, had the effect of decreasing earnings from operations in 1980 by $3.9 million. As previously noted, the company's earnings in 1980 included a charge of $34 million for the "Windfall Profit" tax.

The company's 1979 operating results did not include production from its operating interest as a member of the crude oil consortium in Iran, where oil supply agreements were unilaterally abrogated by the government of Iran during the latter part of 1978. Compared with 1978, sales in the energy business were down $76 million to $628 million. The decrease was primarily due to the complete loss of production in Iran and the sale on January 1, 1979, of a heating oil distribution business. (The 1978 sales included $237 million attributable to these operations.)

Earnings from operations in 1979 were up $48 million, to $66 million, when compared with the prior year. The gain was due to continued natural gas production increases, higher oil and gas prices associated with new domestic energy regulations and internal profit improvement programs. During the fourth quarter of 1979, the company adopted the LIFO method of valuing certain product inventories which were previously valued using the FIFO method. The change, which was made to more closely match current costs with current revenues, decreased earnings from operations by $3.8 million in 1979.

### Other Businesses

Effective January 1, 1981, operational responsibility for RJR Archer, Inc., the Company's packaging products business, and Service Systems Corporation was transferred to a new business unit of the Company—R. J. Reynolds Development Corporation. Service Systems Corporation (formerly included in the foods and beverages line of business) manages food-service facilities and provides contract maintenance, engineering, and security systems for businesses and institutions. The operating results and other financial data of these units are now included in the "Other businesses" captions shown in the Company's lines of business data appearing on pages 46 and 47 of this report. Prior years' results of operations have been restated to reflect this change.

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UNITED BRANDS COMPANY
*Management's Analysis of Operations and Financial Condition*

Operations

Consolidated Results

| (In thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Net sales | $4,058,387 | $3,762,580 | $3,470,222 |
| Operating income | 83,334 | 89,469 | 65,553 |

The Company's net sales for 1981 increased 8% to $4.06 billion principally due to increased sales in the *Bananas and Related Products* and *Meat* segments of the Company's business. In 1980, net sales increased 8% to $3.76 billion, principally as a result of increased sales of *Bananas and Related Products*.

Cost of sales has remained constant as a percentage of sales for the past three years. Cost of sales increased 9% in 1981 and 7% in 1980, primarily as a result of higher costs for wages and fringe benefits, materials, transportation and energy.

Selling, general and administrative expenses increased 1% in 1981. While these costs, particularly salaries, continue to be impacted by inflation, the Company has made reductions in its costs for advertising and promotion, insurance and pensions. In 1980 selling, general and administrative expenses increased 16% reflecting the impact of inflation, primarily on salaries and fringe benefits, as well as an increase in the level of advertising and promotion.

Operating income of $83.3 million in 1981 decreased $6.1 million as a result of declines in the *Bananas and Related Products* and the *Meat* segments of the Company's business, substantially offset by improvements in the *Other Food Products and Food Services* and *Diversified Operations* segments. In 1980 operating income increased $23.9 million to $89.5 million, reflecting improvements in the *Bananas and Related Products, Other Food Products* and *Food Services* and *Diversified Operations* segments of the Company's business, partially offset by a decline in the *Meat* segment.

Interest expense increased 15% in 1981 to $40.6 million and 19% in 1980 to $35.2 million, primarily as a result of increased short-term borrowings at higher average interest rates, partially offset by the reduced average level of long-term debt outstanding during the year and, in 1980 as compared with 1979, by the capitalization of certain interest costs.

Other income and expense increased $3.9 million in 1981 primarily as a result of gains on the sale of capital assets versus losses in 1980, and higher interest income. These increases were partially offset by foreign exchange losses and reduced gains on the reacquisition of certain debentures for sinking fund purposes.

Income taxes reflect an effective tax rate of 44% in 1981 compared with 48% in 1980. The lower rate in 1981 is due primarily to the increased investment tax credits that resulted from a higher level of qualifying capital expenditures.

Bananas and Related Products

| (In thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Net sales | $1,375,093 | $1,231,314 | $939,834 |
| Operating income | 44,833 | 64,373 | 40,161 |

Worldwide sales of *Bananas and Related Products* reached record levels in 1981 principally as a result of increased prices and sales volume of bananas. Operating income for 1981, which was reduced by $19.5 million, was impacted by higher production and transportation costs for bananas which were not fully recovered in the form of increased selling prices. In addition, operating income was adversely affected by the strengthening of the U.S. dollar in relation to certain foreign currencies, as well as by the aftermath of strikes and other labor difficulties which occurred during the first two quarters of the year in various tropical producing divisions.

Sales of *Bananas and Related Products* increased in 1980 principally as a result of favorable selling prices, despite a slight decrease in sales volume due primarily to severe storm damage to banana crops that occurred during the second quarter of the year. Operating income in 1980 increased by $24.2 million due to the favorable selling prices of bananas, partially offset by higher production and transportation costs.

Meat

| (In thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Net sales | $2,322,296 | $2,128,716 | $2,157,334 |
| Operating income | 12,987 | 20,112 | 25,948 |

Sales of *Meat* increased in 1981 principally as a result of increased selling prices of pork. Operating income in 1981 continued to be adversely impacted by losses in the Company's beef business. The decrease in operating income in 1981 resulted from reduced profitability in the Company's fresh pork operations where increased selling prices failed to keep pace with higher costs of live hogs. This decrease was partially offset by improved margins realized in the Company's processed meat operations. In addition, operating income was adversely affected by costs incurred to convert one of the Company's meat packing plants to a distribution center.

Sales of *Meat* decreased slightly in 1980. Operating income in 1980 decreased $5.8 million principally as a result of losses incurred in the Company's beef operation, which were caused by a limited supply and higher costs of cattle for slaughter and the related impact of reduced consumer demand for the higher priced beef products. The decline was mitigated by increased profitability in the Company's pork and processed meat operations which benefited from increased consumer demand for lower priced pork products.

Other Food Products and Food Services

| (In thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Net sales | $208,370 | $274,991 | $265,186 |
| Operating income (loss) | 13,386 | (1,165) | (3,147) |

Sales in 1981 decreased primarily because the Company's vegetable operation is no longer consolidated. It has been combined with an independent fresh produce marketing organization in which the Company has a substantial equity interest. The Company's share of profits and losses from this operation is reflected in operating income of this segment based on the equity method of accounting. Operating income in 1981 increased $14.6 million principally as a result of improvement in the Company's fresh produce operations and the increased profitability of its margarine and shortening operations.

Sales and operating income showed slight improvements in 1980, but earnings continued to be adversely affected by losses in the lettuce and celery operation which suffered from low lettuce and celery prices caused by oversupply and the lingering effects of a labor strike which was settled in September 1979.

Diversified Operations

| (In thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Net sales | $152,628 | $127,559 | $107,868 |
| Operating income | 26,112 | 21,021 | 16,003 |

Net sales increased in 1981 and 1980 and operating income increased $5.1 million in 1981 and $5.0 million in 1980, principally as a result of the continuing growth and increased profitability of the Company's telecommunications and plastics businesses. During the past two years, the Company's international telecommunications subsidiary developed a new nationwide service network to provide international telex service from most major U.S. cities, resulting in a significant increase in U.S. telex traffic and substantial increases in operating income. The Company's plastics operation increased its sales of woven bags, flexible film and PVC pipe and realized significant increases in operating income.

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## CERTAINTEED CORPORATION

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

### Results of Operations

#### Summary

Following three years of economic expansion and industry growth, the 1979-81 period was one of sharp contraction for the Company's principal markets. Marked by two recessions and persistently high interest rates, housing starts declined each year and in 1981 fell to their lowest level in 35 years. During this period of market contraction, petroleum and energy costs were rising significantly as were the costs associated with underutilizing the Company's productive capacity. Competition for available business intensified during this period and the Company was unable to fully pass these and other cost increases through to selling price which further eroded the Company's profits. As a result of the deteriorating market conditions, the Company intensified its cost reduction program which has included permanently discontinuing operations at two production facilities and the temporary shutdown of two others during the 1981 period.

#### 1981

Net sales rose 3% in 1981 from 1980. The increase reflects modest increases in both shipping volumes and pricing. The shipping volume increase occurred in a period of declining economic activity as evidenced by housing starts that fell nearly 16% from a year ago. Profit margins were lowered substantially by the Company's inability to fully pass through cost increases to price in business segments where demand remained soft. Costs associated with lower utilization of the Company's capacity also increased as manufacturing operations in the Building Materials and, to a lesser extent, the Piping Products segments, were scaled down due to declining demand. The small increase in sales and lower margins resulted in a pretax loss of $26.5 million, versus a pretax loss of $2.4 million in 1980.

#### 1980

Net sales declined a nominal 5% in 1980 from 1979. However, physical units shipped declined by an estimated 13% due to the economic downturn, which had a particularly severe impact on new residential construction. Production levels were curtailed to shipment levels in 1980 resulting in good inventory control, but led to a less favorable absorption of fixed charges than had occurred in 1979. The lower level of manufacturing activity, coupled with $10 million of higher depreciation charges, served to reduce margins further. Profit margins also were impacted by numerous other cost increases, especially for energy and petroleum-based raw materials, which due to competitive pressures were not fully recovered by higher prices. A pretax loss of $2.4 million was recorded compared to a pretax profit of $23.7 million in 1979.

#### 1979

Net sales in 1979 rose 2% from 1978, but the increase was more than accounted for by price increases of about 7% between the two periods. The Company also experienced sharp raw material and energy cost increases which it was unable to fully pass through in pricing actions due to the competitive environment. As the result of an extensive three-year capital expansion program, largely completed in 1979, plant start-up costs and added depreciation charges were significant factors in the increase in costs over 1978. Interest expense, resulting from borrowings to finance the final stages of the capital expansion program, coupled with higher rates was nearly $9 million over 1978's level. These cost increases, combined with inadequate pricing and overall unit volumes that were lower than those of the previous year, were the main causes of a $65 million decrease in pretax income.

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Results of Operations

1981

Income from continuing operations of $15.2 million and net income of $15.9 million were Company records and were 100.5% and 25.7% higher than in 1980. Income from continuing operations increased because of changes in the sales mix and programs instituted to increase automation and productivity and reduce expenses. Consequently, cost of sales decreased as a percent of sales from 76.8% in 1980 to 71.2% in 1981. Also, there was a significant increase in interest income.

Income from discontinued operations was larger in 1980 because the Company operated the Stainless Steels Division for a full year, whereas the Division was part of the Company for only one month in 1981. The sale of the Division on February 2, 1981 resulted in a net gain of $608,000.

Net sales in 1981 of $148.4 million increased 3.2% over 1980 sales. The 1980 sales included $8.6 million related to the wood products operations, which were phased out in 1980. Exclusive of wood products, 1981 net sales increased 9.4% over 1980.

Conductor Support 1981 net sales were $84.5 million compared to $84.0 million in 1980. However, the 1980 amount included sales of the Wood Products Division that was phased out in 1980. Exclusive of wood products, Conductor Support sales increased 10.5% in 1981 from 1980. The Hardware and Galvanizing Divisions had higher sales as a result of increased volume and prices. Conductor Support operating income of $10.3 million increased $3.5 million or 51.0%, reflecting improved levels of production and efficiency and changes in product mix. These improvements resulted from 1) the discontinuance of low volume and marginally profitable products, 2) the sale of products to the cable television industry and 3) the realignment of the hardware business by the transfer and consolidation of certain production facilities.

Sales of the Protective Equipment segment increased $4.7 million or 8.0%, primarily from increased volume at the Electronic Systems and Electrical Apparatus Divisions. These increases were partially offset by a decrease in volume at the International Division which was adversely affected by the strong U.S. dollar and weaker foreign economies. Operating income of this group increased $4.6 million or 45.2% because of increased volume, productivity and automation at the Electronic Systems and Electrical Apparatus Divisions.

Interest income increased $7.7 million to $10.0 million, resulting primarily from investment of cash received from the sale of the assets of the Stainless Steels Division and the wood operations, plus retained income from operations. Other income (expense), net is discussed in Note 9 to the Consolidated Financial Statements.

The increase in the effective income tax rate in 1981 to 47.9% from 44.9% in 1980 results primarily from lower investment credits because of reduced capital expenditures in the United States and reduced capital gains benefits related to less gains on the disposition of assets.

1980

The 1980 sales were approximately equal to those in 1979, however, there were changes in sales by business segment (See Note 11). Income from continuing operations increased 30% because of selling higher margin products, reductions in warehouse, selling and administrative expenses, increased interest income and a lower effective tax rate related to capital gains.

Conductor Support net sales declined 10% from 1979 with more than half of the decrease attributable to the planned liquidation of the Wood Products Division. The decline in sales is also related to (a) fewer products being sold by the Hardware Division and (b) the effect of the economic recession. Increases in selling prices offset some of these sales volume reductions. Income from the Conductor Support segment increased 4% from 1979 because of (a) changes to a higher margin product mix, (b) reductions in warehouse, selling and administrative costs and (c) the effects of the adverse winter weather encountered in the first quarter of 1979.

Sales of the Protective Equipment segment increased in 1980 more than $10 million, or almost 22%, while income from this segment improved 8%. The higher sales volume is attributable to international activity, reentry into the suspension insulator market and some price increases to offset increases in costs. Income did not increase in the same proportion as sales because (a) more low-margin products were sold to offset some of the decreased demand related to the slowdown in the economy, (b) costs increased rapidly and (c) selling prices for certain products were reduced because of competitive pressures.

Warehouse, selling and administrative expenses decreased 13% because of cost reductions and a reduction in the number of selling and distribution employees.

General corporate expenses decreased because of the continuation of cost reduction programs.

Other income includes primarily gains from the liquidation of Wood Division assets partially offset by charges for the transfer, consolidation and closing of certain production facilities in Canada and Los Angeles.

Increased interest income results from larger investments with higher rates of interest.

The 1980 effective income tax rate is lower than in 1979 primarily because of lower tax rates applied to $1.4 million of capital gains in 1980.

Income from discontinued operations represents the earnings of the Stainless Steels Division. This business was sold in February, 1981. The improvement in 1980 is attributable to a $2 million increase in sales related to higher selling prices and changes in product mix. Higher margins combined with the non-recurrence in 1980 of problems encountered in 1979 such as the extra costs associated with extended maintenance of the 38" mill, caused 1980 earnings to increase substantially.

## MARATHON OIL COMPANY

*Financial Review*

*Management's Discussion and Analysis of Results of Operations and Financial Condition*

### Results of Operations

1981 Compared to 1980

Total net income for the year 1981 was $343.1 million, a decrease of 9.5%, compared with $379.0 million for 1980.

The results for 1981 were affected by investment advisory and legal fees incurred by Marathon as a result of the recent tender offers to the extent of $11 million, or 19 cents per share. Costs associated with the anticipated release and settlement of outstanding employee stock options provided for in the Merger Agreement reduced 1981 net income $29.9 million, or 51 cents per share.

Income from domestic production and exploration operations amounted to $533.9 million, compared with $369.0 million in 1980. Domestic production of liquid hydrocarbons declined by 1.4%, while natural gas production decreased by 1.7%. Crude oil revenues were up significantly as the result of the January 28, 1981 decontrol order. The increased revenues were largely offset by the "windfall profit" tax. Higher realizations for crude oil and natural gas more than offset the slightly lower levels of volumes produced. Exploration expense in the United States for 1981 was $112.2 million, up slightly from the $108.0 million in 1980.

Income from our domestic refining and marketing operations totaled $47.9 million, a substantial decline from the $80.9 million earned in 1980. Although earnings declined in 1981, profit margins in the second half of the year showed substantial improvement because of declines in crude oil costs and more than offset the loss sustained in the first half of 1981. Sales volumes of refined products declined 1.3% from 1980.

Foreign exploration and production operations resulted in a loss of $62.2 million in 1981, a substantial increase from the $9.7 million loss for 1980. The increased loss is attributable to an aggressive exploration program and reduced per barrel profitability on equity crude oil liftings. Exploration expenses totaled $173.2 million, an increase of $89.0 million when compared with 1980. Tanker liftings of equity crude oil were 64,912 barrels per day, down 44.3% from 1980. Natural gas production from the Kinsale Head field offshore Ireland, was up 52.5% from the 1980 level.

Marathon's European refining and marketing operations recorded a loss of $12.3 million in 1981, compared to income of $17.9 million in 1980. Increased crude oil costs outpaced refined product realizations during 1981, substantially reducing the margin on the sale of refined products. Sales of refined products in 1981 were down 22.9% from a year ago.

Income from Marathon's worldwide transportation and minerals activities for the year 1981 amounted to $25.1 million, compared with $34.1 million in 1980. Minerals operations exploration expense increased to $29.4 million, up from the $24.9 million in 1980.

The net loss from the corporate activities increased to $189.3 million in 1981 from $113.2 million in 1980 due primarily to increased interest expense, general inflationary trends, investment advisory and legal fees, and costs associated with the settlement of employee stock options. Interest costs, after deduction of capitalized interest of $58.3 million, were $159.4 million, up from the $123.3 million in 1980. No interest costs were capitalized in 1980. The capitalized interest added $31.5 million to net income or 53 cents per share in 1981.

Comments on the impact of inflation are included in Note O to the Consolidated Financial Statements.

Dividends totaling $117,860,000, or $2.00 per share, were paid to Marathon's shareholders in 1981. On an annualized basis, this dividend rate represents a payout of 34.4% on 1981 earnings.

During the year, Marathon acquired 1,500,000 shares. The total number of treasury shares at December 31, 1981 was 2,867,298.

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1980 Compared to 1979

Total net income for the year 1980 was $379.0 million, an increase of 17.3%, compared with $323.2 million in 1979. Income in 1979 included an extraordinary credit of $28.0 million reflecting the benefits of tax loss carryforwards from operations at Marathon's refinery in West Germany.

Income from domestic exploration and production activities increased to $369.0 million in 1980 from $235.9 million in 1979. Domestic production of liquid hydrocarbons declined by 3.5%, while natural gas production increased by 4.1%. Revenues were up from crude oil as the gradual decontrol of crude oil prices resulted in improved realizations. Profitability was greater during 1980 as the improved realizations were sufficient to offset the "windfall profit" tax and the expenses of sharply increased exploration efforts. Exploration expense in the United States for 1980 was $108.0 million, up from $77.1 million in 1979.

Income from domestic refining and marketing increased to $80.9 million in 1980, up from $14.5 million in 1979. The increase was achieved despite a decline of 16.1% in the total volume of refined products sold. Gasoline volumes declined 12.2%, reflecting price-induced conservation efforts by the motoring public. Fuel oil volumes declined 26.5%, principally because of a basic shift in home heating demand. Average realizations for Marathon's total product mix were higher, offsetting sharply increased crude oil costs and resulting in improved margins, particularly in the first half of the year.

Foreign exploration and production operations resulted in a loss of $9.7 million, compared to an income of $24.6 million in 1979. This decrease reflects sharply increased exploratory effort directed toward improving worldwide reserves. Exploration expense outside the United States rose to $84.3 million, compared to $43.3 million in 1979. Tanker liftings of equity crude oil were down by 6.0%. Significantly reduced per-barrel profitability and higher exploration expenses resulted in the loss.

Income from refining and marketing operations in Europe decreased to $17.9 million in 1980, compared with $103.5 million in 1979, due to sharply lower margins and a decline in sales volumes of refined products sold. Total sales volume of refined products declined by 17.5%, a reflection of worldwide conservation efforts. Net income in 1979 includes an extraordinary credit of $28.0 million, or 46 cents per share, reflecting the reduction of West German taxes resulting from utilization of net operating loss carryforwards.

Income from Marathon's worldwide transportation and minerals activities was $34.1 million in 1980, about the same as in 1979. Minerals exploration expense increased to $24.9 million from $16.5 million in 1979.

The net loss from the corporate activities increased to $113.2 million in 1980 from $90.0 million in 1979. Interest cost increased $13.3 million due to higher levels of borrowing and interest rates. Foreign currency exchange losses were $11.3 million versus a small gain in 1979, reflecting a weakening of the deutsche mark and other foreign currencies in relation to the dollar.

Comments on the impact of inflation are included in Note O to the Consolidated Financial Statements. Because of the significance and possible misinterpretation of this experimental disclosure, Marathon encourages a cautious and careful review of Note O.

Dividends totaling $117,730,000, or $1.95 per share, were paid to the Company's shareholders in 1980. In the second quarter, the quarterly dividend was increased from 45 cents per share to 50 cents per share. On an annualized basis, this dividend rate represents a payout of 31.9% on 1980 earnings.

During the year, Marathon acquired 500,000 shares. The total number of treasury shares at December 31, 1980, was 1,369,180.

## NATIONAL PRESTO INDUSTRIES, INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

1981 Compared to 1980

Net sales increased by $4,720,000 from $117,952,000 to $122,672,000, or 4%, with approximately one-half of this increase coming from the Company's commercial product lines.

Gross profit for 1981 decreased $2,315,000 due to product mix and downward movement of pricing on major lines provoked by competitive onslaughts upon the Company's trade position. Despite this pricing movement, operating margins were nevertheless sustained at acceptable levels.

Other income increased from 1980 due to a higher level of invested funds and the realization of a higher rate of return on short-term marketable securities.

Earnings from continuing operations before provision for income taxes increased $2,609,000 from $34,246,000 to $36,855,000, or 8%. The provision for income taxes decreased from $16,790,000 to $16,151,000, principally as a result of an increase in tax exempt interest due to additional tax exempt securities in the marketable securities portfolio purchased primarily in the fourth quarter and state income taxes. The effective income tax rate decreased from 49% to 44% in part from the increase in tax exempt earnings (as described more fully above) and also as a result of a decrease in the effective rate for state income taxes.

In October, 1980, the Company sold United Truck Leasing, Inc. and its subsidiary operations effective June 29, 1980, at a price nominally above book value.

Like other companies, double digit inflation posed severe difficulties for this Company. To avoid the potentially adverse consequences of such inflationary pressures, it was necessary for the Company to address and resolve exposures posed by rapidly accelerating costs in combination with constraints on pricing.

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1980 Compared to 1979

Net sales increased by $16,774,000 from $101,178,000 to $117,952,000, or 17%, primarily as a consequence of increased sales of the Company's commercial product lines.

Gross profit for 1980 increased $10,905,000 due to increased sales and a favorable product mix in the Company's commercial product lines.

Other income increased from 1979 due to a higher level of invested funds and the realization of a higher rate of return on short-term marketable securities.

Earnings from continuing operations before provision for income taxes increased $11,960,000 from $22,286,000 to $34,246,000, or 54%. The provision for income taxes increased from $11,073,000 to $16,790,000 principally as a result of increased earnings. The effective income tax rate remained approximately the same for both periods. Net earnings from continuing operations increased $6,243,000 from $11,213,000 to $17,456,000, or 56%.

In October, 1980, the Company sold United Truck Leasing, Inc. and its subsidiary operations effective June 29, 1980, at a price nominally above book value.

Net earnings increased $6,255,000 from $11,183,000 to $17,438,000, or an increase of 56%.

## OTHER CLASSIFICATION BASIS

BAUSCH & LOMB INCORPORATED
*Financial Review*

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Results of Operations

Sales (Continuing Operations)

Sales from continuing operations for the year ended December 27, 1981 totaled $533.3 million, an increase of 11% over 1980. The average compound growth rate of sales from continuing operations over the past five years has been 17% and for the past three years has been 16%. A summary of sales by industry segment for 1981, 1980 and 1979 follows:

Sales by Industry Segment

| (Dollar Amounts in Thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Vision Care | | | |
| Contact lens products | $201,553 | $176,403 | $139,740 |
| Consumer products | 145,441 | 130,763 | 114,360 |
| | 346,994 | 307,166 | 254,100 |
| Instruments | 186,306 | 174,636 | 146,092 |
| Net Sales | $533,300 | $481,802 | $400,192 |

In the company's vision care business, sales of contact lens products in 1981 increased 14% over 1980, compared to a 26% increase in 1980 over 1979. Unit sales of contact lenses in 1981 increased 30% over 1980 principally due to continued good growth in replacement sales and the strong acceptance of the company's new toric lens for the correction of astigmatism. Average unit prices declined as a result of new pricing programs introduced early in 1981. Sales of lens care products rose strongly as a result of sharply higher demand for contact lens solutions.

Consumer products sales rose 11% over 1980. Bushnell products sales were up sharply, while sales of the company's Ray-Ban sunglasses were approximately even with last year due to reduced consumer spending.

Sales of instruments were 7% higher than in 1980. Particularly good sales growth was achieved by the company's digital plotters used with home and small office computers and also by its basic spectroscopy systems line. Other instrument products, notably industrial microscopes and machine tool controls, were adversely affected by unfavorable economic conditions.

Total company sales in markets outside the United States were $151.8 million in 1981 up $12.3 million or 9% from 1980. This compares to a 10% increase in 1980 over 1979. In domestic markets, sales were up 11% compared to a 25% increase in 1980 over 1979. If sales of the company's international subsidiaries had been translated into U.S. dollars at 1980 exchange rates, total revenues for 1981 would have increased 16% over 1980.

## Operating Earnings (Continuing Operations)

Operating earnings from continuing operations were $111.9 million in 1981, up 7% from $104.6 million in 1980. The average compound growth rate of operating earnings over the past five years has been 18%, and for the past three years has been 17%. Operating earnings by industry segment for the last three years are shown below:

Operating Earnings by Industry Segment

| (Dollar Amounts in Thousands) | 1981 | 1980 | 1979 |
|---|---|---|---|
| Vision Care | | | |
| Contact lens products | $ 71,202 | $ 64,066 | $ 51,823 |
| Consumer products | 27,969 | 25,488 | 25,276 |
| | 99,171 | 89,554 | 77,099 |
| Instruments | 12,690 | 15,009 | 15,840 |
| Operating earnings | 111,861 | 104,563 | 92,939 |
| Interest, foreign currency fluctuations, and corporate administrative expense | (28,225) | (10,491) | (8,369) |
| Earnings from continuing operations before income taxes | $ 83,636 | $ 94,072 | $ 84,570 |

Operating earnings of contact lens products rose to $71.2 million for the year ended December 27, 1981, increasing 11% in that year, after a 24% increase in 1980, and a 16% increase in 1979. Operating earnings as a percentage of sales were 35% in 1981, 36% in 1980, and 37% in 1979. Lens production at the company's new plant in Ireland, where costs are currently higher than in the company's U.S. plant, increased significantly at the end of 1981. However, this negative impact on operating earnings was more than offset by the favorable tax rate applicable to income from Irish operations.

Consumer products operating earnings rose 10% in 1981 following a 1% rise in 1980, and an increase of 34% in 1979. In 1981, Bushnell products operating earnings increased sharply while sunglass earnings were essentially unchanged.

Instrument operating earnings declined 15% for the year. These earnings for 1981 included a first quarter charge of $3.5 million to discontinue an instrument manufacturing plant in France. After tax benefits, this charge amounted to $2.4 million or $.20 per share. This amount, previously reported as part of a reserve established in the first quarter for non-recurring items, has been subsequently reclassified as a charge to operations.

## Research and Development

Research and development expenditures have been primarily associated with contact lens and instrument products. Expenditures in 1981 amounted to $21.0 million compared to $16.7 million in 1980 and $13.2 million in 1979.

### Cost of Products Sold

The ratio of cost of products sold to sales was 45% in 1981 and 43% in 1980 and in 1979. The increase in 1981 resulted from a combination of contact lens product price reductions and higher costs in Ireland, in addition to slightly higher costs in the instrument segment during the first half of 1981.

### Selling, Administrative and General Expenses

Selling, administrative and general expenses totaled $150.7 million in 1981, or 28% of sales, down from 30% in 1980 and 29% in 1979. The decrease in expenses relative to sales in 1981 occurred primarily as a result of cost reduction programs implemented in the company's Instruments Group.

### Interest and Other Expenses

Interest expense was $9.7 million in 1981, $4.5 million in 1980, and $4.6 million in 1979. The 1981 increase resulted from higher levels of borrowing to fund working capital requirements and from higher rates of interest. Other expenses, consisting primarily of corporate administrative costs, were $12.2 million in 1981, $7.1 million in 1980 and $3.9 million in 1979. Measures implemented in 1981 to restructure the company and strengthen business operations are contributing to increased corporate administrative expense.

### Foreign Currency

Foreign currency fluctuations decreased 1981 aftertax earnings from continuing operations by $5.3 million or $.44 per share, compared to an increase of $.8 million or $.07 per share in 1980, and a decrease of $.1 million or $.01 per share in 1979.

### Income Taxes

The year 1981 benefited from a lower average tax rate of 43% on earnings from continuing operations, compared to rates of 44% in 1980 and 47% in 1979. The 1981 rate was a function of several factors including DISC benefits, utilization of loss carryforwards in foreign subsidiaries, tax savings from operations in Ireland, additional investment tax credits, and the recently enacted research and experimental expenditures tax credit.

### Discontinued Operations

The company's discontinued ophthalmic business incurred net losses of $4.3 million in 1981, excluding discontinuance reserves of $7.3 million and $25.8 million established in the first and fourth quarters, respectively. These losses stemmed from adverse economic and marketing conditions, and included interest, direct corporate expenses and currency effects attributable to this business. In 1980, these discontinued operations lost $2.3 million before non-recurring gains of $2.1 million.

### Price Level Changes

The company has been affected, as have most businesses, by changes in the purchasing power of the dollar, particularly during the period of high inflation over the last several years. The company's reported results of operations reflect much of the impact of inflation because the last-in, first-out method is used to determine cost of domestic inventories. This results in the current cost of products sold being charged in the Statement of Earnings. In addition, because the company has acquired a significant percentage of its properties during the last five years, a large part of the inflationary effects has been recognized in the provision for depreciation charged against earnings. For a more detailed summary of the effects of changing prices, refer to pages 42 and 43.

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## BORG-WARNER CORPORATION

*Management's Discussion and Analysis*

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For Borg-Warner, 1981 was an excellent year in many respects. We improved earnings in the face of weak markets. We maintained our strong financial condition. The stock was split 2 for 1, and the dividend was raised 13%.

Yet, as we celebrate our accomplishments, it's good that we keep them in perspective. For some of them pale when adjusted for inflation. Even though the rate was lower than in either of the prior two years, inflation is still an insidious burden that gnaws at our financial underpinnings and benefits no one.

Another sobering fact was the general weakness of our consolidated manufacturing operations in 1981. While 1981 earnings from consolidated manufacturing operations, at $64 million, improved a little from a dismal 1980, they remained far below the record $120 million in 1979. If adjusted for inflation, the comparison is even worse.

Clearly, we have reduced, but in no way eliminated, the impact of the cyclical nature of our largest markets on overall results. The automotive and construction markets remained firmly in the grip of recession, spending by industry was down, the economy in general was weak.

We did as well as we did in that environment because there is a new Borg-Warner emerging.

## Credit Where Credit Is Due

Most of the credit for the good year in 1981 goes to our growing service businesses and our equity in the earnings of affiliates—primarily the Hughes Tool Company. Combined equity and service business earnings accounted for 63% of 1981 net earnings, compared with 56% in 1980 and only 23% in 1979.

A continuing program of aggressive asset management also contributed to 1981 results, as was the case in both 1980 and 1979. Our operating units improved their inventory turnover and days' sales in receivables from both 1980 and 1979 levels. In addition, we have continued to improve our cash collection and disbursement systems. The combination of these factors lowered our working capital needs and the amount it would have otherwise been necessary to borrow.

The record $4.00 per share earned in 1981 includes a number of nonrecurring items and accounting changes, which offset each other.

Here are the pieces:

- A charge of 43 cents per share provided for the sale or closing of operations no longer compatible with our long-range objectives.
- A provision for the withdrawal from a manufacturing product line resulted in a pre-tax gain of about $20 million. The gain consists of a profit on the sale of a 40% interest in a Japanese joint venture, reduced by a provision for the probable disposition or scale-down of a consolidated unit. However, because of different tax rates, the net effect on earnings per share was a reduction of less than one cent.
- The sale of a plastic modifier plant in Scotland added 17 cents per share to earnings.
- A change in interest rate assumptions reflecting added income we expect to receive from pension fund investments increased earnings by another 17 cents per share.
- The adoption of FASB Statement 34 requiring the capitalization of interest on assets acquired over an extended period added 11 cents to 1981 per-share earnings. The amount in prior years was not material.

In addition, we adopted FASB Statement 52 regarding the treatment of foreign currency translation. The effect on 1981 Borg-Warner earnings was not material.

## The Last Three Years and the One Ahead

The prior three years can be characterized as follows: The year 1979—the end of the boom between the recessions of 1975 and 1980—was the strongest year ever for our consolidated manufacturing operations and by every measure when adjusted for inflation.

The recession that began in 1980 resulted in lower production as well as sales. The year was a poor one for Borg-Warner. In 1981, our primary markets remained weak. From an operating standpoint, the year began and ended on a soft note. In between, there was some improvement in volume. And although 1982 also had a sluggish beginning, we expect to show a modest gain in manufacturing operations for the year as a whole.

## Results of Operations

Sales for the year were up 3% in historical dollars from 1980 and 1% from 1979. Increases in price rather than volume accounted for the 1981 sales gain overall.

Borg-Warner net earnings in 1981 were 36.5% above those of the prior year and 10.6% higher than for 1979—the previous record. Consolidated manufacturing earnings for the year were up 17% from 1980 but 46% below those of 1979.

Comparing total net income, including that from unconsolidated services operations and equity affiliates, with consolidated manufacturing sales results in a reported total return on sales of 6.2%—Borg-Warner's best in more than 10 years. However, return on sales from consolidated operations alone was only 2.3%, up slightly from 2.1% in the previous year but down substantially from 4.4% in 1979.

Of the manufacturing groups, chemicals and plastics had the highest operating margin at 9.2% in 1981, about the same as in the prior two years. Despite improvement in each of the last two years, the air conditioning business was the poorest contributor with a disappointingly low operating margin of 5.3%. The Energy and Industrial Equipment group had been the best performer in 1980 and 1979 with operating margins of about 11% for both years. Its return fell to 7.5% in 1981 due to a weak electric utility market and costs connected with plant start-ups and closings.

Borg-Warner's return on average equity (R.O.E.) was 14.5% in 1981, much improved from 11.4% in 1980 but below the 15.4% for 1979. The 1981 rebound resulted from business mix changes and improved consolidated operations.

Research and development investment was $66 million, equal to 2.4 cents of each sales dollar. This is the same ratio as in 1980 and above the 2.1 cent ratio in 1979. Borg-Warner considers R&D a critical investment and will continue to spend a significant portion of its sales dollar to introduce new technology into the corporation and to develop new and proprietary products for the future.

The effective 1981 income tax rate for consolidated operations of 46.8% compares with 46.1% in 1980 and 36.3% in 1979. The 1981 and 1980 tax rates were affected primarily by losses in the U.K. which had no offsetting tax benefits. The unusually low effective rate in 1979 resulted primarily from U.K. inventory credits and the favorable settlement of prior years' tax issues.

### The Impact of Inflation

The rate of inflation in 1981 was 10.4% based on the average consumer price index/urban. In the last five years, inflation has averaged 9.8% annually.

How has Borg-Warner done in this environment of high inflation? Pretty well relatively speaking. The right column on the bottom of page 38 shows our average real growth for the five years beginning in 1977. Our performance exceeded inflation by every measure with the exception of sales.

And how have Borg-Warner shareholders done? Also relatively well. Combined dividends paid and stock price appreciation have provided shareholders since the beginning of 1977 an average annual return of 18%. Inflation destroyed a big part of that, but our shareholders have received a *real* return on their investment that averaged about 7% annually for this period.

### Operations Outside the U.S.

Over the last three years, Borg-Warner consolidated sales outside the U.S. have held quite steady at a little more than 30% of the total for the company. This does not include U.S. export sales averaging $275 million annually. During the same period, profit outside the U.S. has steadily declined. Outside the U.S., operating profit exceeded 20% of the companywide total in both 1979 and 1980 but fell to 12% in 1981.

Margins have continued to deteriorate, particularly in Europe. Average operating profit of non-U.S. units was less than 3% in 1981—about half that of 1979.

Geographic performance varied widely. Australian units, with 1981 sales of $280 million, have been standouts showing consistent growth in sales and operating profit since 1979. Operating margins for those units in 1981 averaged 11.6%—better than for any of the manufacturing groups overall.

In Europe, the 1981 provision for a product line withdrawal completely offset operating profit, which was about even with 1980. This resulted in an operating loss of $19.4 million for the year for European operations.

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### Further Improvement in 1982

At this point we are optimistic that 1982 earnings will be another record for Borg-Warner. The economic outlook at the beginning of the year is uncertain at best; but, even without an economic recovery, we expect continued improvement in our service businesses and affiliate earnings and a modest improvement in our consolidated manufacturing operations. If demand picks up in any of our major markets, the earnings gain could be quite substantial.

## THE EASTERN COMPANY

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

In 1981 net income decreased 23% from the 1980 level and 43% from 1979. Funds of $3,726,360 generated from operations were sufficient to cover dividends, capital expenditures, and operating needs.

## Results of Operations

Sales for 1981 increased 7% over the 1980 level. The increase was primarily due to the introduction of new products in the mine roof support and industrial hardware areas. An overall volume decrease of 1% and a minimal overall price increase of 1% were due to a work stoppage at one of our plants early in the year, the ten-week coal mine strike, as well as product mix, economic conditions, and extensive price competition. The sales in 1981 decreased 2% from the 1979 level.

Increased sales were experienced in the mine roof support, industrial hardware and high security lock areas, and more than offset decreases in the transportation hardware, castings, marine and construction supply areas that were affected by the slowdown in the economy and high interest costs.

Sales increases between 1979 and 1981 in the areas of mine roof supports and high security locks were not sufficient to offset sales decreases in the other market areas.

The 1981 net income was 23% lower than the 1980 level because of the ten-week coal mine work stoppage, and also a loss in the marine segment. The latter included a $650,000 inventory write-off of a discontinued product line. Price competition did not allow for full recovery of such fixed cost increases as labor, depreciation, utility, insurance costs, etc. overall.

The 1981 net income was 43% lower than the 1979 level because of reduced sales and increased fixed costs such as depreciation, salaries, fringes, utilities, selling and marketing expenses.

Fourth quarter earnings in 1981 were $.26 per share (after LIFO) or $303,871 on sales of $16,785,014, compared with the 1980 fourth quarter earnings of $.52 per share (after LIFO) or $590,858 on sales of $14,771,580. The 1979 fourth quarter earnings were $.58 per share (after LIFO) or $660,422 on sales of $16,799,078.

The reduction of fourth quarter earnings between 1981 and 1980 was due to lower unit sales prices, product mix, inventory write-offs, and increased fixed overhead costs, such as utilities, depreciation, and insurance. Earnings in the fourth quarter of 1981 were lower than the fourth quarter of 1979 because of higher material, labor, utility, depreciation and other overhead costs.

The costs of products sold were 81.7% of 1981 sales; 80.3% of 1980 sales and 79.6% of 1979 sales. The increased costs and overall margins have been affected by product mix, the ten-week coal strike, price competition, and such cost increases as utilities, depreciation and insurance.

The company plans to improve margins through volume increases, the concentration on profitable market segments, improved operating efficiencies through capital expenditure programs, continued cutbacks of unnecessary overhead costs, additional product development, and additional price increases where possible. The company is committed to product and market expansion through research and development projects.

In 1981 research and development costs were 10% over 1980 and 51% over the 1979 level. Of the total $550,000 spent, the major emphasis was on marine, locking device hardware, and mine roof support projects.

Selling and administrative expenses in 1981 increased $612,525 or 8% over the 1980 level and $540,465 or 7% over the 1979 amount. These were primarily due to normal wage and fringe benefit increases, as well as additional advertising and marketing costs resulting from additional product development.

Each year's fourth quarter earnings are affected by year-end adjustments to bring estimated accruals, LIFO provisions, and book inventories to actual. In 1981 such adjustments amounted to $.02 per share versus $.14 in 1980 and $.07 per share in 1979.

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## Impact of Inflation and Changing Prices

Inflation continues to be a significant factor in our economy and the company is continually seeking ways to cope with its impact. Price competition was especially intensive throughout 1981. The company was successful in passing increased costs by increasing selling prices over a period of time in some product lines and market areas. However, in those market segments hardest hit by the economic downturn and high interest rates, competition restricted such increases. As a result, the overall price increase was limited to a nominal 1%. The 2% sales decrease between 1981 and 1979 was primarily due to volume decreases.

The company uses the LIFO method of accounting for its inventories. Under this method, the cost of products reported in the financial statements approximates current costs and thus reduces distortion in reported income due to increasing costs. The charges to operations for depreciation represent the allocation of historical costs incurred over past years, and are significantly less than if they were based on the current cost of productive capacity being consumed. Provision for depreciation is generally computed using accelerated methods.

Approximately 53% of the company's properties have been acquired over the last six years and have a remaining useful life, ranging from four years for equipment to thirty-four years for buildings.

Assets acquired in prior years will be replaced at higher costs, but this will take place over many years. While these new assets will result in higher depreciation charges, in many cases, there will be operating savings due to technological improvements and improved efficiency and increased productivity. The company considers these matters in setting its pricing policies.

INTERCO INCORPORATED
*Management's Discussion and Analysis of Results of Operations and Financial Condition*

Results of Operations

Fiscal 1982 represented the first full year of operations for Broyhill in the Furniture and Home Furnishings Group. For fiscal 1981, the Furniture Group includes operating results for a full year for Ethan Allen and for three months of Broyhill. For fiscal 1980, the Furniture Group includes the operating results of Ethan Allen for the month of February 1980. These acquisitions were accounted for as purchases; and accordingly, their operations have been included in the consolidated statements from their respective dates of acquisition. Also, fiscal 1981 has been restated for the retroactive adjustment of accounting for compensated absences in accordance with the Financial Accounting Standards Board Statement No. 43.

Sales—During the past three years, net sales have increased 12.9%, 17.0% and 9.3%, respectively. Each major operating group contributed to the increases with record sales. The primary reason for the 12.9% increase in fiscal 1982 and the 17.0% increase in fiscal 1981 was due to the inclusion of the Furniture and Home Furnishing Group.

Cost of Sales and Selling, General and Administrative Expenses—As a percent of sales, cost of sales and expenses for the past three years were 91.3%, 90.5% and 90.6%, respectively. The increase in fiscal 1982 was the result of added sales promotions which adversely affected gross profit margins.

Interest Expense—Interest expense increased to $37.2 million in fiscal 1982 from $20.3 million in fiscal 1981, which increased from $9.3 million in fiscal 1980. The increases in fiscal 1982 and 1981 were attributable to the assumed debts of the purchased companies, an increased level of short-term borrowing, at higher rates, to finance operational needs and the issuance of new debt.

Net Earnings—Net earnings decreased by 2.1% in fiscal 1982 following increases of 13.6% and 15.3% in fiscal 1981 and 1980, respectively. Fiscal 1982 earnings were adversely affected by the depressed retail profit margins and increased interest expense. Earnings of the manufacturing segments of the company have continued to be strong over the three-year period while earnings of the general retail segment were affected by above normal markdowns and the higher cost of doing business.

Earnings Per Share—Earnings per share were $7.23, a decrease of 2.6% from the restated $7.42 in fiscal 1981, after increases of 1.0% and 15.4% in the two previous years, respectively.

The increase in fiscal 1981 was less than the increase in net earnings due to the inclusion in average shares outstanding of the common stock equivalents of the preferred stock issued for the acquired company. In fiscal 1980, average shares were reduced by treasury shares purchased and increased by the common stock equivalents of the preferred stock, which was in the average for one month, thus producing a slightly higher increase in per share earnings as compared to the net earnings increase.

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KEYSTONE CONSOLIDATED INDUSTRIES INC.
*Management's Discussion and Analysis of Financial Conditions and Results of Operations*

Results of Operations

Net sales in 1982 decreased 12% from 1981. The severe recession in key markets resulted in lower demand for most of the Company's major lines of business. Volume declines were particularly sharp in the second and third quarters of the year. No significant price increases were obtained under these conditions, and unfavorable changes in product mix also accounted for a portion of the lower dollar sales volume. Net sales in 1981 were 1.3% higher than in 1980, representing virtually no change in physical volume or prices from year-to-year. However, volume in the first half of that year was significantly lower than in the comparable period of the previous year.

The 1982 net loss of $13,420,000, which included an extraordinary tax credit of $1,342,000, was due primarily to the significant decrease in physical volume for the year. The net loss in 1981 compared to 1980 was due to the slightly higher sales volume and lower cost of goods sold. The net loss in 1980 included a $1,667,000 gain on the sale of the Company's investment in Jefferson Bank.

Cost of goods sold as a percent of sales was 89.7% in 1982, 88.4% in 1981 and 89.9% in 1980. Total employment costs as a percent of sales were 42.1% in 1982, 39.1% in 1981 and 42.0% in 1980.

Interest costs increased by 7.4% in 1982 due to a higher level of average daily borrowings at a slightly lower average interest rate than 1981. Interest costs decreased 18.9% in 1981 over 1980 due to lower average daily borrowings.

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# III

## FINANCIAL CONDITION

Under SEC definitions, financial condition refers to liquidity and capital resources. Liquidity refers to the ability of an enterprise to generate adequate amounts of money to meet the enterprise's need for money. Capital resources refers to (1) plant and equipment, (2) the source of the money used to purchase them, and (3) the mixture of equity, debt, and off-balance sheet financing. Liquidity and capital resources may be discussed separately or in combination in the management discussion and analysis section of the annual report.

The companies surveyed for this publication treated the discussions of liquidity and capital resources in three ways:

- The discussions of liquidity and capital resources were kept separate.
- The discussions of liquidity and capital resources were completely combined.
- The discussions of liquidity and capital resources were combined except that certain aspects of liquidity or capital resources or both were discussed separately.

A substantial majority of the companies surveyed completely or partially combined the liquidity and capital resources discussions.

Fifteen examples are presented below of liquidity and capital resources discussions that are separate or completely or partially combined.

### SEPARATE DISCUSSION

ALUMINUM COMPANY OF AMERICA
*Management's Discussion and Analysis of the Results of Operations and Financial Condition*

Liquidity and Capital Resources

Cash Flow and Working Capital—The company's Statement of Changes in Consolidated Financial Position, shown on page 32 of this report, has been modified to more clearly depict cash flows from the major activities of the business. The company believes this format is a more meaningful presentation of its sources and uses of funds. The Statement shows that funds provided from operations in 1981 were significantly less than for the prior two years. Consequently, additional borrowings were required, principally for expenditures for properties, plants and equipment.

Working capital increased in 1981, principally due to the growth in inventories. Inventories are expected to be reduced during 1982 to more desirable levels.

Net receivables from customers of $567.6 are down from $717.5 at year-end 1980 reflecting the lower sales volume in the fourth quarter of 1981. Payment experience has not deteriorated, however, and Alcoa's turnover rate declined only slightly.

Capital Expenditures—Expenditures for properties, plants and equipment for 1981 were $677.8, six percent above the 1980 level. As the economic environment and outlook changed during the year, several projects were delayed or stretched out, resulting in expenditures considerably below those projected at the start of the year. Productivity, capacity-sustaining and environmental programs continued to receive major emphasis in the capital expenditure plan. Flat-rolled products expansion projects at Davenport, Iowa and Lebanon, Pa. were near completion at year-end. Modernization of the alumina production facility at Mobile, Ala. was curtailed in the last half of the year. Production capacity increase and sustaining projects at the Point Comfort, Tex. alumina production facility progressed toward a mid-1982 completion. The power project in Texas continued, but on an extended schedule. Projects to improve capacity of smelting facilities at Rockdale, Tex. and Warrick, Ind. were started along with construction of the third potline at Badin, N.C. However, the latter project has been delayed. Expansion of forging capacity at Cleveland, Oh. is in progress and further construction progress payments were made toward new vessels for the company's shipping fleet.

Capital expenditures for 1982 are projected to be $575, the bulk of which will be spent to sustain operations. Construction of an alumina chemicals plant and an extrusion plant, both in Louisiana, will begin in 1982.

Investments—Investments in foreign entities not wholly owned increased $15.3 in 1981. Additional investments, principally in Brazil, were partially offset by redemption of preferred shares by an affiliate and payments of loans by subsidiaries. Investments for 1982 are projected to be $63, most of which will be to support Alcoa's expansion activities in Brazil.

Cash dividends received from foreign entities not wholly owned were $3.7 in 1981, $42.7 in 1980 and $28.8 in 1979. Because of the continuing need to provide capital for Alcoa of Australia's major construction projects, its shareholders agreed to receive 1981 dividends in common stock rather than cash. Alcoa received cash dividends of $27.3 in 1980.

The company's investment in Alcoa Properties, Inc. (API) increased by $32 in 1981, resulting principally from profits generated by real estate sales. API expects to spend approximately $13 in capital projects in 1982 and expects to fund this amount through internally generated funds and borrowings.

Capital Resources and Debt—In the five-year period 1976-1980, Alcoa met its financing needs principally through internally generated funds. Surplus cash was invested in short term securities and used to reduce borrowings. Debt as a percent of invested capital dropped from 41.4 percent in 1976 to 26.3 percent in 1980, thus strengthening Alcoa's capital structure. In 1981, however, the combination of lower earnings, increased working capital and higher capital expenditures resulted in net cash outflows. To meet these cash requirements, Alcoa arranged several financings.

In January 1981, $150 of 13⅞% Sinking Fund Debentures Due 2011 were sold.

In April, proceeds of $120.9 were obtained from the sale of $250 of 7% Debentures Due 2011 which were offered at 48.362% of the principal amount to yield 14.7% to maturity.

In November, proceeds of $161.6 were obtained from the sale of $300 of 7% Debentures Due 1996 which were offered at 53.864% of the principal amount to yield 14.7% to maturity.

As a result of the additional debt in 1981, Alcoa's debt as a percent of invested capital at year-end was 31.0 percent.

On February 2, 1982 Alcoa exchanged approximately 1.75 million shares of its common stock for $59.0 principal amount of its sinking fund debentures. The debentures involved and their principal amounts were: 6%—$14.6; 7.45%—$19.6; 9%—$15.8 and 9.45%—$9.0. The exchange will result in a net gain of approximately $22 in the 1982 first quarter.

In early 1982 Alcoa entered into a $750 bank credit agreement with a group of banks, replacing the $500 credit agreement arranged in early 1981. The agreement provides for a revolving period of 10 years. Beginning in the sixth year of the agreement, the amount available is reduced by $100 per year and in the ninth year by $150. In addition to this agreement, Alcoa maintains lines of credit with several banks totaling $100. The company also has issued commercial paper for which it currently has A1/P1 ratings.

Under the present economic conditions, it is anticipated that Alcoa will be a net borrower in 1982. The amount of debt required will depend on a number of factors, including the timing of the expected upturn in the economy and the success of the planned inventory reductions.

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## Working Capital

Working capital and the current ratio at January 30, 1982 were $163,384,000 and 1.31 to 1 compared to $133,429,000 and 1.27 to 1 at January 31, 1981 and $139,095,000 and 1.29 to 1 at February 2, 1980. The working capital and current ratios remained relatively constant during these periods. The slight change in the current ratio was primarily due to the Company's efforts to maximize the use of its assets by taking advantage of the best payment terms from vendors and controlling inventory levels.

The graph in the margin demonstrates the ever-increasing investment the Company has in inventory levels. When examining these inventory levels, it is necessary to analyze the components that cause the actual inventory levels of the Company to vary from year to year. Inventory levels generally vary for three reasons:

1. The addition of net new store square footage to the inventory base. This represented an increase in our total store square footage of 1.2% in 1981 to 26,923,287 square feet and 4.7% in 1980;
2. The inflationary impact on the replacement of inventory;
3. Real change in the inventory levels needed to meet real sales increases.

One method of determining the Company's maintenance of its inventory at appropriate levels is to calculate the inventory turns on an annual basis. The Company had inventory turns of 10.0 times, 9.7 times and 10.1 times in 1981, 1980 and 1979, respectively. As can be seen from this calculation, the Company has maintained relatively constant inventory levels in relation to its sales base. Other components of working capital maintained levels similar to those in the previous year.

## Short-Term Borrowings

The Company uses short-term borrowings for seasonal inventory buildups as well as to finance construction projects prior to long-term debt placement. Average short-term borrowings amounted to $24,989,000, $15,431,000 and $12,521,000 in 1981, 1980 and 1979. The average interest rate on these borrowings amounted to 15.54% in 1981, 15.05% in 1980 and 12.11% in 1979. The average prime interest rates for these same periods were 18.49%, 15.70% and 12.87%. The maximum short-term borrowings outstanding in each were $55,000,000 in 1981, $69,100,000 in 1980 and $22,500,000 in 1979. There were no short-term borrowings at year-end. At January 30, 1982, the Company had available $116,000,000 in short-term bank lines of credit, as well as an $80,000,000 letter of credit facility, with a group of three banks, which is used to support commercial paper borrowings. The Company believes that these lines of credit are adequate to meet short-term cash needs over the next few years.

## Debt to Equity

In 1981 the Company's proceeds from long-term borrowings were $8,152,000 compared to $110,244,000 in 1980 and $192,726,000 in 1979. The larger borrowings in 1980 and 1979 were primarily associated with the merger with former American Stores Company. The details of these borrowings are discussed in the notes to Consolidated Financial Statements under the headings "MERGER" and "LONG-TERM DEBT." However it is significant to note that the Company has reduced its long-term borrowings in spite of maintaining an aggressive real estate program as well as having an increase in working capital. Actual 1981 capital expenditures, which include the present value of the leases that are required to be capitalized under current accounting requirements, amounted to $118,900,000 compared to the $110,000,000 originally forecast. This represents a 23 percent reduction of approximately $35,069,000 from the $153,969,000 in 1980. The Company expects to increase its capital expenditures to approximately $135,000,000 in 1982. The Company is committed to having a larger portion of capital expenditures financed by internally generated funds. The graph to the left shows that funds provided from operations, plus the proceeds from the sale of surplus property, have, as a percent of capital expenditures, increased in each of the last two years.

The Company continues its effort to strengthen its debt-to-equity ratio, having paid off $37,890,000, $66,085,000, and $40,849,000 in long-term debts and obligations under capital leases in 1981, 1980 and 1979. These reductions are net of replacement debt but include payments of current maturities associated with long-term borrowing. These pay-downs, coupled with a lower level of long-term borrowings, have reduced long-term debt and capitalized leases by $13,825,000 in 1981 and $7,402,000 in 1980. Common shareholders' equity increased $45,725,000 in 1981 over 1980 and

$33,122,000 in 1980 over 1979. This improvement, coupled with a decrease in long-term debt, reduced the Company's debt-to-common shareholders' equity to 1.31 to 1 in 1981, from 1.61 to 1 in 1980 and 1.90 to 1 in 1979. These ratios demonstrate the Company's long-term commitment to strengthen its financial position and bring its financial ratios more in line with those of the pre-merger company.

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GENERAL REFRACTORIES COMPANY
*Financial Analysis and Review*

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Liquidity and Capital Resources

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Working Capital

Consolidated working capital at year-end 1981 was $27.4 million, a decrease of $40.7 million from 1980. The decrease is attributable to the reclassification to current of debt payable to domestic banks, the 1981 operating losses and the translation of European currencies into U.S. dollars at lower rates of exchange. In 1980 consolidated working capital of $68.1 million increased $4.7 million over the 1979 balance primarily as a result of the extension of the maturity on certain European short term debt. Also during 1980, a $26.3 million reduction in receivables was used primarily to reduce short term debt and finance increased inventories.

As more fully explained in Note 11 to the consolidated financial statements, the Company is negotiating with various potential lenders new short and long term domestic lending arrangements to improve its working capital position. While the Company anticipates reporting a greater loss in the 1982 first quarter than incurred in the first quarter 1981, the 1982 business plan contemplates a reduced operating loss, attainment of which is subject to various uncertainties including some second half 1982 recovery by the steel and construction industries. In 1982 it also plans the disposal of certain domestic assets, principally real estate, no longer required in its operations and the reduction of inventories and receivables to provide working capital and improve liquidity.

Various foreign lending arrangements provide the Company's foreign subsidiaries with informal lines of credit to finance temporary increases in working capital requirements.

Long Term Debt

Consolidated long term debt net of current maturities decreased by $13.8 million in 1981 to $38.4 million. This compares to an increase of $.6 million in 1980 to $52.2 million. The 1981 decrease is attributable to reclassification to current of debt payable to domestic banks partially offset by increased borrowing in Europe to finance the capital expenditures discussed below. In 1980 domestic debt decreased $3.2 million. Additional long term financing will be required to fund the Company's planned modernization and expansion programs. If worldwide inflation continues unabated, despite efforts to reduce and control the level of inventories and accounts receivable, additional financing may be required to support higher levels of these items. At December 31, 1981, long term debt represented 46% of common shareholders' equity compared to 52% in 1980 and 53% in 1979.

Capital Expenditures

During 1981 the Company expended $9.1 million toward completion of facilities to manufacture mineral wool insulating products in Austria principally for central European markets. This project was financed by a combination of internal cash flow and external funds, the latter, with benefit of interest subsidies, representing the greater portion of the financing requirement. During 1981 other capital expenditures were restricted primarily to those necessary to maintain production in the interest of conserving the Company's cash resources. Expenditures for two projects to expand the refractories and insulating products lines are planned for 1982 and early 1983. The cost would be approximately $6.3 million, construction of which depends on the availability of long term external financing.

HMW INDUSTRIES, INC.
*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Liquidity

During 1981 working capital increased $13,628,000 or 46 percent due principally to proceeds from the public offering of the Silver Indexed Bonds ($15,200,000) and a $2,000,000 increase in the revolving credit borrowings. These increases were reduced by the partial prepayment of the promissory note to the former shareholders of Industrial Bolt & Nut Co. (IBN), the acquisition of Howard Hardware Products, Inc. (Howard) and capital expenditures. In 1981 inventories increased $15,857,000 and were financed principally through short and long-term debt.

Seasonal cash requirements are financed through bankers' acceptances, revolving credit borrowings and subsidiaries' bank lines of credit.

At January 31, 1982, the Company had available an additional $5,000,000 under its revolving credit agreement.

Capital Resources

In 1981 the Company completed its major capital expenditures programs for new operating facilities for its defense and metal products businesses and building improvements for the operating facilities of the furniture businesses.

The Company has no major capital expenditures planned for 1982.

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HUMANA INC.
*Financial Discussion and Analysis*

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Liquidity

Over the past five years, funds provided from operations totaled $545 million, including $177 million in 1981 compared to $145 million in 1980 and $110 million in 1979. During each of the past five years, funds provided from operations substantially exceeded the sum of cash dividends paid and scheduled maturities of long-term debt. The excess was used to finance expansion, improve existing property, prepay certain debt and increase working capital.

Depreciation and amortization of existing property, equipment and intangible assets will exceed currently scheduled maturities of long-term debt for the next five years, leaving the balance of funds provided from operations for expansion, improvements to existing property, and payment of cash dividends.

At August 31, 1981 working capital totaled $114 million. Management believes that current working capital levels are more than adequate to meet liquidity needs of the base business.

Capital Resources

Capital expenditures were $166 million in 1981 compared to $170 million in 1980 and $148 million in 1979. Renovation, expansion, and improvements are generally financed 25% from operations and 75% from new long-term debt.

At August 31, 1981 the Company had capital spending commitments approximating $120 million for the construction of new hospitals and expansion or improvement of existing facilities. Fifty million dollars in external debt financing has been arranged and an additional $40 million is expected to be obtained, primarily through mortgage debt at market rates and terms which are generally less favorable than rates and terms for debt currently outstanding. The remainder will be funded from operations.

Capital resources in excess of current commitments are available for further expansion. Resources include existing cash and cash equivalents, $125 million unused bank revolving credits, new mortgage debt, equipment leases and equity issuances.

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## COMPLETE COMBINATION OF DISCUSSIONS

CHOCK FULL O'NUTS CORPORATION
*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Liquidity and Capital Resources

The Company's financial condition continues to be very strong. Since January 1980, there have been no borrowings. As of July 31, 1981, working capital has increased to $17,269,000 and the ratio of current assets to current liabilities is 3.3 to 1. In addition, cash and cash equivalents and marketable securities exceed total current liabilities. The Company's convertible subordinated debentures were due and paid on August 1, 1981. Long-term debt, capital lease obligations and other non current liabilities in relation to stockholders' equity are very favorable; the Company has a debt to equity ratio of .18 to 1. Due to steadily increasing earnings, stockholders' equity is in excess of 68% of total assets, providing a solid base for any borrowings that might be required to finance future acquisitions.

The Company's centrally controlled cash and working capital management systems provide for maximum investment of excess cash. Interest income on short-term investments was approximately $1,200,000 for fiscal 1981 compared to $230,000 for the prior year. Interest expense was less than $500,000.

The Company has continued to modernize its plant and facilities spending in excess of $1,850,000 in fiscal 1981. Productive capacity is considered adequate to meet future expansion needs.

The Company believes that its present liquidity position is sufficient to satisfy any known demands.

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FANSTEEL INC.
*Management's Discussion and Analysis of Financial Condition and Results of Operations*

1981 Compared to 1980

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Liquidity and Capital Resources

Cash flow was favorable by comparison with the prior year principally because of a decrease in inventories, an increase in accounts payable at year-end, a smaller investment in fixed assets, and a reduction in common stock dividend payout. Cash requirements for the ensuing year are not expected to change materially from 1981.

1980 Compared to 1979

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Liquidity and Capital Resources

Cash requirements essentially were provided by operations. Fansteel purchased all of the shares of Pasco Gear & Machine, Inc. from an affiliated company for approximately $5.0 million. An inventory increase of $7.2 million was recorded of which $1.5 million resulted from the acquisition of Pasco Gear & Machine, Inc. A major portion of the remainder of inventory increase represented a commitment to a very substantial influx of new orders for metal fabrications. The relatively small change in receivables reflected the sales volume downturn late in the year. The fourth quarter sales rate was about the same as a year ago.

Additions to property, plant, and equipment of $9.1 million was a record high for the Company. Most of the expenditures were for equipment with emphasis on upgrading for automation and quality control. There was a nominal commitment for purchases in 1981 of machinery and equipment. Capital requirements were not unusually high.

INGERSOLL-RAND COMPANY
*Management's Discussion*

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Liquidity and Capital Resources

The company's financial position improved in 1981 over 1980 through improved asset management and higher net earnings from operations. In 1981, all of the company's requirements for funds were generated internally; the heavy requirements in 1980, primarily for the acquisitions of Knight Industries and the Oilfield Products Group, formerly the Machinery Division of Cabot Corporation, were met by incurring long-term debt.

The following table reflects the company's performance in managing its investment.

| | 1981 | 1980 |
|---|---|---|
| Working capital (in millions) | $1,079 | $1,056 |
| Current ratio | 2.4 | 2.5 |
| Average working capital to net sales (%) | 31.6% | 33.3% |
| Average days outstanding in receivables | 73.8 | 75.6 |
| Average months supply of inventory | 7.5 | 7.7 |
| Debt-to-total capital | 37/63 | 41/59 |

Monitoring of receivables and inventory levels during 1981 produced a reduction in the amount of working capital necessary to support each dollar of sales. Receivables were lower by $10.8 million at year end. As a percent to net sales, receivables improved to 22.2%, the lowest level in the past five years. Inventories increased, but at a lower rate (9.9%) than sales (13.7%).

Short-term borrowings at year-end 1981 were $191.1 million, as compared to $219.9 million at year-end 1980. The average amount outstanding during 1981 was $216.4 million, as compared to $231.1 million in 1980. The weighted average interest rate during 1981 was 18.5% compared to 13.5% during 1980. Despite lower short-term borrowings in 1981, interest expense increased due to higher rates.

The company and its finance subsidiary had domestic short-term credit lines at December 31, 1981, of $350.0 million and foreign bank credit facilities of $242.4 million to insure availability of funds for working capital purposes. These facilities, which exceed projected requirements for 1982, also provide support for commercial paper borrowings. Total unused credit facilities at December 31, 1981, were $468.2 million.

Consolidated long-term debt of $564.6 million at December 31, 1981, declined $25.2 million from year-end 1980 primarily from the stock/debenture exchange noted above.

In total, borrowings decreased $54.0 million in 1981 as compared to an increase of $208.1 million in 1980. As a result, year-end 1981 borrowings provided 37% of capital and equity 63%, improving from year-end 1980 when borrowings represented 41% and equity 59%.

Capital expenditures were $150 million in 1981 compared to $131 million in 1980, an increase of 14.8%. The company continued to invest to improve manufacturing productivity, reduce costs and incorporate advanced technologies into existing facilities. The 1981 expenditures also included eight new plants or major plant expansions.

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THE SINGER COMPANY

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Financial Condition

1981

During 1981, funds used for capital expenditures, and dividends and other items, exceeded funds provided from operations and proceeds from disposition of excess property, plant, and equipment. As a result, additional borrowings were necessary. A major element of the capital expenditures and the increase in debt originated from a $26 million capitalized lease obligation for the new headquarters office building. The proceeds from sales of excess properties resulted from a program now largely completed.

Accounts receivable increased in 1981 because of expanded volumes of sales in Products and Services for Government and in Consumer Sewing Products and Consumer Durables in the Africa, Latin America, and Far East area. These increases were partially offset by a decrease in receivables for Sewing Products operations in Europe, resulting from reduced sales volume and the effects of foreign currency translation. Receivables were slightly lower in the Products Manufactured for the Consumer area due to reduced fourth quarter sales.

Inventory decreased from the prior year, reflecting effective management of the balance sheet. Inventory levels were substantially lower in the North America and Europe Sewing Products area in line with the lower level of sales coupled with a higher proportion of dealer sales and fewer models resulting from the program to restructure these operations. Inventory levels were essentially unchanged despite substantially greater sales in the Products and Services for Government area owing to a higher proportion of percentage of completion contract sales in 1981. Inventory increased in proportion to sales volumes in Consumer Sewing Products and Consumer Durables in the Africa, Latin America, and Far East area.

Notes and loans payable increased in the Africa, Latin America, and Far East area to finance the expanded dimensions of these operations. In the United States, notes and loans payable increased primarily because of required funding of expenditures associated with the program to restructure sewing operations. These increases were offset to some extent in the European Sewing Products area where notes and loans payable were reduced due to lower inventory and receivables levels, and proceeds from property sales. Taxes payable were reduced due to lower effective tax rates and pretax income.

1980

In 1980, funds provided by the sale of excess property, plant, and equipment, by operations, and by a decrease in investments were more than sufficient to fund additions to property, plant, and equipment, net reductions in long-term debt, and dividend payments. However, additional short-term borrowings were necessary to support increases in accounts receivable and inventories.

Accounts receivable levels increased in 1980 because of increased sales volumes in Consumer Sewing Products and Consumer Durables in the Africa, Latin America, and Far East area and in Products and Services for Government. Inventories also increased in these businesses as higher stocks were required to meet the expanding dimensions of their operations. Increased sales volumes in the Meter Products Division also required the maintenance of higher inventory levels. These inventory increases were partly offset by lower balances in the North America and Europe Consumer Sewing Products area, Controls Products, and in Air Conditioning and Heating Equipment, reflecting reduced sales volumes in those product areas. Cash and cash equivalents decreased due to a lower level of cash in transit. Taxes payable increased in 1980 because of the increased level of earnings in the Company's foreign operations.

Liquidity and Capital Resources

It is the Company's policy to maintain accounts receivables and inventories at minimum levels necessary for its diversified operations. Non-productive current assets such as cash and trade receivables which yield little or no interest income are held to a minimum owing to the current high cost of funding.

The Company's current assets have consistently represented over two-thirds of total assets. This allows effective balance sheet management to provide a high level of operating liquidity. Products and Services for Government has a particularly high turnover rate for inventory because of long-term contracts which require progress payments by customers on a percentage of completion basis. These operations also receive advance payments on certain contracts which reduce the related financing requirements. Inventory levels and receivables are high in the Africa, Latin America, and Far East area because the Company's operations are dependent upon extensive distribution networks and the willingness to extend instalment credit.

The Company maintains a number of contractual relationships with its lenders which enable it to draw cash as necessary to meet short-term liquidity requirements. The principal current domestic source is the 1979 Revolving Credit Agreement, as amended, which extends through 1987. See Note 11 of Notes to Financial Statements—Long-Term Debt for a discussion of this Revolving Credit Agreement. This flexible access to funds enables the Company to take advantage of a variety of financing sources. Because of this, working capital tends to understate the Company's liquidity position.

The Company has recently maintained a continuing capital expenditure program of over $60 million per year in various areas of its operations. Current examples of these include facility expansions in Aerospace and Marine Systems, a centralized wood kiln and mill for Furniture operations, and expansion of household sewing machine manufacturing capacity in Taiwan. The Company expects to arrange additional borrowing facilities over the next few years in order to ensure the viability of this program. Except as described in Note 12 of Notes to Financial Statements, the Company did not have any material commitments for capital expenditures at December 31, 1981.

WILLAMETTE INDUSTRIES, INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Liquidity and Capital Resources

Traditionally, the Company has been able to generate sufficient funds internally, via net earnings and non-cash charges against earnings, such as depreciation, stumpage and deferred income taxes, to meet its cash flow requirements relating to working capital, cash dividends, debt service and capital expenditures for property, plant and equipment. However, because of the extremely poor market conditions for building materials and extensive capital expenditures in 1981, the Company has utilized external borrowings to meet a portion of its cash flow requirements.

During 1981, the Company had short-term borrowings under revolving credit lines with several banks, none of which was outstanding at December 31, 1981. These borrowings were supported by a $31 million commitment for term loan financing which was replaced in September 1981, with a $75 million revolving credit agreement with a number of banks. Borrowings under this agreement will automatically convert to a term loan at December 31, 1982 and $65 million was outstanding at December 31, 1981.

Also, in 1981, the Company incurred long-term financing of $13 million through two industrial revenue bond issues, $10.2 million from the manufacturer of the fine paper machine which began operating in December 1981 at Hawesville, Kentucky and $8.4 million for the purchase of equipment and small tracts of timber and timberlands. In addition, the Company's working capital has increased to $87 million and the current ratio has improved to 1.89 in 1981 from 1.67 in 1980. Conversely, the Company's ratio of long-term debt to equity has increased to 57.1% at December 31, 1981 from 39.6% at December 31, 1980.

The Company is continually making capital expenditures for normal improvements in its manufacturing facilities to improve fiber utilization and labor efficiency. As part of this process, the Company has expended approximately $25 million in 1981 for these capital expenditures with a like amount budgeted in 1982. During 1981, the Company completed the following significant capital projects:

1. A new fine paper machine at Hawesville, Kentucky with a total cost of approximately $75 million, of which $47 million was expended in 1981.
2. A new business forms plant in the Dallas-Fort Worth area.
3. A major expansion and modernization of the Aurora, Illinois corrugated container plant with a total cost of approximately $4.6 million.

In addition, the Company has the following significant capital projects in progress at December 31, 1981:

1. An expansion and modernization of the Port Hueneme, California paper mill with an approximate total cost of $25.5 million.
2. A remodeling of a paper machine at the Albany, Oregon paper mill with an approximate cost of $6.5 million.
3. Expansion and modification of the Campti, Louisiana paper mill, with a total estimated cost of $12 million.
4. Modernization of two plywood plants at an approximate cost of $3.4 million.

Approximately $28.7 million has already been expended on the above projects and the remaining source of funds is anticipated to be principally from internally generated funds with additional outside financing to be incurred as necessary. In addition, the Company currently has on file with the Securities and Exchange Commission a registration statement for a proposed public offering of $100 million ten-year notes. If utilized, the funds would be used both to prepay bank term loans tied to the prime interest rate and to partially finance capital expenditures for property, plant and equipment in 1982.

See Note 6 to the consolidated financial statements for discussion of contingencies.

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## PARTIAL COMBINATION OF DISCUSSIONS

AIR PRODUCTS AND CHEMICALS, INC.
*Management's Discussion and Analysis*

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Liquidity, Capital Resources and Other Financial Data

Decisions on capital expenditures and the financing of those expenditures are carried out within the framework of specific financial guidelines and analytical disciplines which focus largely on cash flow.

Capital Expenditures

Capital expenditures for the year were $323 million. The continuing high level of capital expenditures primarily reflects the on-going expansion of production and distribution capacity in industrial gases, particularly in the domestic tonnage gas business. Increased demand for gases in traditional applications and newer applications is expected to continue to provide a high level of capital investment opportunities. Profitable expansion opportunities in certain chemical product lines are also anticipated. Other capital expenditures are made for cost reduction, energy conservation, and health, safety and environmental considerations.

In 1982, capital expenditures are expected to exceed $400 million. The company's five-year strategic plan through 1986 includes a planned capital expenditure program in excess of $2.5 billion.

Capital expenditure decisions are based on new customer orders, long-term strategy considerations and return criteria. The expected internal rate of return of proposed projects is evaluated against an established minimum, or "hurdle", rate appropriate for a specific product line. Hurdle rates reflect management's assessment of operational and financial risks and capital structure policies.

## Financing, Capital Structure and Cash Flow

Although capital expenditures in 1981 continued at a high level, a substantial increase in internal funds generated enabled the company to reduce long-term debt. This increase in internal funds generated included over $70 million of nonrecurring cash flows from a settlement of litigation and from customers' advances. At year end, total long-term debt (including current portion of long-term debt, limited recourse financing and preferred stock of a subsidiary) expressed as a percentage of the sum of total long-term debt and shareholders' equity was 36%, compared with 41% at the close of 1980. In addition to scheduled repayments of debt, a $50 million variable rate term loan was prepaid.

Because of persistent high interest rates, the company has delayed the issuance of any new long-term debt.

In 1981, commercial paper outstanding peaked at $21 million, which is the amount outstanding at year end, compared with a peak of $75 million in 1980. The company's commercial paper is supported by committed long-term bank credit arrangements. An increase in the utilization of commercial paper financing is expected in 1982.

The company maintains substantial committed long-term lines of bank credit for the purposes of supporting commercial paper and to assure adequate liquidity under foreseeable circumstances. Such lines have a final maturity of three to seven years and amounted to $150 million throughout 1981. Borrowings of $40 million outstanding under these lines at 30 September 1981 were repaid in early October. Subsequent to year end, agreement was reached to increase these lines to $290 million. The company's European subsidiaries also had unutilized committed long-term lines of bank credit of $16 million at year end.

From time to time, the company also utilizes pollution control and industrial development bond financing, leasing, joint ventures and other financing arrangements.

The company expects to be a substantial issuer of long-term debt in the future which, when added to retained earnings and other internally generated cash, will be used to finance its continuing growth. In targeting the optimum mix of debt and equity, consideration is given to a number of key financial ratios. Two of the more important ratios used in judging prudent debt capacity are annual internal funds generated expressed as a percent of average total long-term debt and interest coverage. These and other more detailed ratio analyses, together with judgments concerning the quality and certainty of future cash flows, have led to a targeted long-term debt ratio for the company in the range of 38% to 42% based on the present mix of the business portfolio. It is expected that this target range may be increased slightly in the future reflecting more capital expenditures associated with long-term tonnage gas contracts that generate highly predictable cash flow streams.

The company is highly capital intensive and an important part of its internal funds generated comes from tax deductible noncash capital charges and investment tax credits generated by new investments. It is expected that the recently enacted Economic Recovery Tax Act of 1981, which shortened the tax life of plant and equipment, will serve to further accelerate total internal funds generated in the future.

## Working Capital

Investment in net working capital was $109 million at the end of 1981, $121 million at the end of 1980 and $106 million at the end of 1979. The current ratio was 1.3 at the end of each of these years. The company historically has had a low current ratio compared to broad industrial averages primarily for the following two reasons. Investment in industrial gases inventory is extremely low because of the nature of the business. Secondly, a substantial portion of accounts payable is associated with capital projects under construction rather than with normal trade purchases for manufacturing because the company acts as its own prime contractor on most of its capital projects.

The company expects that it will continue to report a low current ratio. The continuous maintenance of large unused committed lines of credit previously discussed provides an ample source of supplemental liquidity to cover short and medium-term swings in cash requirements.

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## Liquidity and Capital Resources

Funds provided from operations were 7 percent less than in 1980, and continued to be insufficient to support the expanded capital investment program, working capital needs, dividends paid to stockholders and, in 1981, the $307 million repurchase of Common Stock. To meet these requirements, total debt (long-term and short-term) increased in 1981 by $835 million.

Bank lines of credit are available in the amount of $1.3 billion (reduced from $4.3 billion at year-end 1981) to ensure flexibility and liquidity. At December 31, 1981, $400 million had been drawn down under the agreements of which $100 million was classified as short-term debt.

Scheduled maturities of long-term debt and capitalized lease obligations will amount to $30 million in 1982. Capital additions and dividends are estimated to approximate $1.3 billion. These cash requirements are expected to be met primarily through funds from operations. The level of short-term debt that will be outstanding during 1982 will depend on working capital needs, interest rate opportunities and the proceeds from the disposal of properties, if any.

Long-term debt added in 1981 consisted of the following: (a) $250 million of 13⅞% thirty-year debentures of which $178 million represented refinancing of commercial paper outstanding at year-end 1980; (b) $300 million of 7% thirty-year debentures sold at a discount of $150 million; (c) $150 million of 17% Guaranteed Notes due in 1988 issued in the Euro-Dollar market by a foreign subsidiary and guaranteed by the Company; and (d) $300 million of notes payable in 1989 under a revolving credit agreement with a group of banks at various rates in connection with the purchase of Common Stock from Nu-West Group Limited. Commercial paper and other short-term debt totaled $343 million at year-end 1981.

The ratio of long-term debt and capitalized lease obligations to capitalization was 45 percent, an increase over the 33 percent average ratio for the four previous years. The increased leverage is considered by Management to be a temporary condition. The Company's financial plan is designed to constrain further significant growth in consolidated debt and to reduce leverage over a reasonable time. Elimination of capital requirements for the plastics businesses together with funds from the write-off and disposal of these operations and from the possible sale of the Minerals segment properties are expected to add to the Company's liquidity over the next two years. Supplemental funding for acceleration of the exploration and development program has been arranged through partnerships with major insurance companies (see page 5).

Working capital at December 31, 1981 was $241 million. The current ratio was 1.2 compared with 1.4 at year-end 1980. Working capital position is stronger than indicated since approximately 88 percent of the product inventories are carried at LIFO cost (see note 1 to the financial statements).

## Capital and Exploration Expenditures

Capital expenditures reached a record level $1.4 billion in 1981, a 25 percent increase over 1980. Capital expenditures have grown at an annual rate of 21 percent over the past five years. The 1982 program will continue to concentrate on worldwide energy exploration and development and will also include refinery enhancements, natural gas liquids investments and the new headquarters building in Tulsa.

Capital and exploration expenditures for the past five years follow.

| ($ millions) | 1981 | 1980 | 1979 | 1978 | 1977 |
|---|---|---|---|---|---|
| (a) Capital expenditures | 1,369 | 1,091 | 758 | 637 | 501 |
| Exploration expenses | | | | | |
| (b) Geological, geophysical and other costs (charged directly to expense) | 175 | 138 | 99 | 91 | 82 |
| (c) Dry hole costs and unproved lease impairment (initially capitalized, subsequently expensed) | 200 | 156 | 112 | 140 | 97 |
| (d) Total exploration expenses | 375 | 294 | 211 | 231 | 179 |
| Total expenditures (lines a+b) | 1,544 | 1,229 | 857 | 728 | 583 |
| Percent dedicated to energy supply | 86% | 84% | 84% | 87% | 91% |

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DUPLEX PRODUCTS INC.
*Management's Discussion and Analysis*

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Financial Condition

Over the last three years, working capital has steadily increased from $28.0 million at the 1978 year-end to $44.2 million as of October 31, 1981. The current ratio has consistently been strong for this period, ranging from 2.9 to 1 up to 3.6 to 1. Receivables have increased proportionately with sales during this time and inventories have been relatively flat based on the LIFO valuation method, ranging from $14.3 million to $15.4 million.

The Company's capital expenditure, dividend and working capital requirements have been generated internally except for the 1979 industrial revenue bond financing of our Atlanta plant for $5.0 million. During 1979 and 1980, minimal short-term borrowings of up to $3.0 million were made, but none were required in 1981. Currently, negotiations are being finalized for about $10.0 million of industrial revenue bond financings for the Sycamore, Illinois and Newark, Ohio projects.

Long term debt as a percentage of total capitalization was about 17% at year-end. If the planned $10.0 million financing mentioned above had been completed at October 31, the ratio would have been 27%. At the end of fiscal 1978, the debt/capitalization ratio was about 24%.

Stockholders' equity has grown from $34.8 million at the end of 1978 to $58.9 million as of October 31, 1981, an increase of 69%. At the 1981 year-end, our equity per common share equivalent was $14.76.

Capital Expenditures

Capital expenditures in 1981 were $5.1 million or slightly less than the $5.7 million for 1980. Major expenditures were for the new business forms plant at Newark, Ohio and the new corporate headquarters at Sycamore, Illinois. Planned expenditures for fiscal 1982 are $9.0 million which are primarily for completion of the Ohio and Illinois projects. In fiscal 1979, capital expenditures were $4.3 million.

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JOHNSON & JOHNSON
*Management's Discussion and Analysis of Results of Operations and Financial Condition*

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Liquidity and Capital Resources

Cash and marketable securities (including the non-current portion) totaled $620.5 million at year-end 1981 as compared to $503.0 million at year-end 1980. Total borrowings were $287.1 million at year-end 1981, compared to $237.1 million at year-end 1980. In 1981, working capital increased by $123.5 million.

The Company views cash and marketable securities as its principal measure of liquidity. Internally generated cash provides the major source of funds for growth of the business, including additions to property, plant and equipment, although selected debt has and will continue to be a source of financing business opportunities.

The Company has access to sources of funds at numerous banks worldwide. While the total amount of credit available is not readily quantifiable, international subsidiaries' unused lines of credit approximate $250 million. Total credit available is deemed sufficient to meet the needs of the Company. Both long-term and short-term debt have been increasing in absolute terms and primarily relate to the borrowings of international subsidiaries. However, the Company's percentage relationship of total borrowings to equity, 11.4%, remains relatively low.

Property Expansion and Expenditures

Information relating to property, plant and equipment:

| (Dollars in Millions) | 1981 | 1980 |
|---|---|---|
| Additions to property, plant and equipment | $388.5 | 364.0 |
| Depreciation and amortization | 152.4 | 138.7 |
| Investment tax credits | 12.3 | 8.2 |
| Investment tax credits amortization | 5.9 | 5.1 |

1981 additions to property, plant and equipment exceeded 1980 additions by $24.5 million, or 6.7%.

Domestic additions included administrative facilities for Johnson & Johnson Baby Products Company in New Jersey and manufacturing facilities for Ethicon in New Mexico and Janssen Pharmaceutica in Puerto Rico. Major construction is in progress in New Brunswick, New Jersey for the Worldwide Headquarters. Building construction was also completed during 1981 in Argentina, Germany, Great Britain, Ireland, Italy, Peru and South Africa.

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PITNEY BOWES INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

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Liquidity and Capital Resources

Working capital totaled $190.6 million at the end of 1981, up 9 percent from year-end 1980, while the current ratio increased to 1.45 to 1 from 1.42 to 1. The improvement in both working capital and the current ratio resulted in part from the issuance of common stock in mid-1981, the $28.7 million proceeds from which were used to reduce short-term borrowings. Inventories on a first-in, first-out (FIFO) costing basis decreased $2.1 million in 1981 and on a last-in, first-out (LIFO) basis decreased by $18.1 million due to actions the company has taken to slow inventory growth. Cash and short-term investments increased $20.9 million in 1981. Short-term borrowings totaled $25.6 million at year-end 1981 compared to $71.1 million in 1980 and $17.2 million in 1979. The increase in these borrowings during 1980 was required principally to finance increased inventory levels, while the decrease in 1981 results in part from the mid-year equity offering.

At year-end 1981, the company had unused lines of credit and revolving credit facilities totaling $74.5 million in the U.S. and $54.9 million outside the U.S. ($44.5 million for leasing operations in Canada) which it expects should be sufficient, together with cash generated internally to finance working capital needs for 1982.

The ratio of short- and long-term debt to the total of such debt and stockholders' equity decreased to 27.4 percent at year-end 1981 from 34.1 percent at year-end 1980 reflecting the issuance of additional common stock and the reduced short-term borrowing levels. Requirements for debt are expected to arise from the construction of a corporate office facility in 1982 and 1983, unless a sale/leaseback is executed.

Book value per share of common stock at year-end 1981 increased 8 percent to $26.20 from $24.25 at year-end 1980.

Capital Investments

Net additions in 1981 to property, plant, and equipment were $50.1 million, compared with $51.3 million in 1980. The additions to property, plant, and equipment were due to plant and manufacturing equipment improvements, expenditures for new corporate offices, and expansion of manufacturing capabilities. Net additions to rental equipment, including related work-in-process inventory, were $50.4 million compared with $43.1 million in 1980. The increase in net additions to rental equipment was due primarily to the increased production and placement on rental of postage meters including replacement programs. Net additions in 1982 to property, plant, and equipment, including expenditures related to a new corporate office facility, are expected to approximate $60 million and net additions to rental equipment are expected to approximate $70 million.

At December 31, 1981, commitments for acquisition of property, plant, and equipment included commitments for the construction of the new corporate office facility expected to be completed in 1984. All other commitments were in the normal course of business.

Return on Capital

Return on invested capital declined to 10.2 percent in 1981 from 12.0 percent in 1980 and return on stockholders' equity declined to 13.8 percent from 16.4 percent. These declines reflect the several factors described above. The company expects an increase in revenue and net income in 1982. This expected improvement in net income coupled with continued asset management programs is expected to result in an increase in return on invested capital and stockholders' equity.

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# IV

## COMPLETE PRESENTATIONS

A difference in the industry or industries of operation is an important reason why the management discussion and analysis of one enterprise differs from that of another enterprise. Seventeen examples are presented below of complete management discussion and analysis presentations of enterprises that operate in different industries. Manufacturing enterprises are omitted from the examples because they are the principal source of the examples in Chapters 2 and 3.

### ADVERTISING

FOOTE, CONE & BELDING COMMUNICATIONS INC.
*Discussion and Analysis of Financial Condition and Results of Operations*

Results of Operations—1981 Compared to 1980

Consolidated worldwide revenues increased 3.4% from $164,743,000 to $170,309,000. U.S. revenues increased approximately 7% while non-U.S. volume declined 3%. Non-U.S. revenues were adversely affected during 1981 by declines in the value of foreign currencies against the U.S. dollar. On a comparable exchange rate basis, non-U.S. revenues would have increased approximately 9.3% and consolidated revenues would have increased 7.7%.

Salaries and employee benefits increased 5.1% from $102,004,581 to $107,209,238. The decline in foreign currencies referred to above also affected salaries and employee benefits. On a comparable translation rate basis, salaries and employee benefits would have increased 9.1%. The increase in salary expense is primarily due to inflation as the number of employees was largely unchanged. Employee benefits increased due to higher profit sharing provisions and payroll taxes as a result of higher profits and a greater salary base.

Office and general expenses for 1981 increased 6.7% from $44,142,832 to $47,120,500. If exchange rates had remained constant from 1980 to 1981, the increase would have been 13.1% and is primarily the result of inflation.

Other income was $2,214,706 higher in 1981 than in 1980. Included in the 1981 number is $843,000 of gain from the purchase of tax benefits. The balance of the increase in other income is accounted for by higher interest and discount income.

The 1981 tax provision of $10,699,000 (a rate of 48.5%) compares to $11,422,000 (a rate of 50.8%) in 1980. The 1980 rate was favorably affected by a non-recurring tax credit of $371,000 related to United Kingdom dividends paid prior to 1980. The 1981 tax rate benefited from a new U.K. tax credit related to inventories in the amount of $763,000. The 1981 rate also was reduced due to the inclusion in pretax profits of non-taxable income from the purchase of tax benefits.

## Results of Operations—1980 Compared to 1979

Consolidated worldwide revenues increased 19.9% from $137,426,756 to $164,743,148. U.S. revenues increased approximately 14% while non-U.S. revenues increased about 34%. Approximately $5,480,000 of this increase was due to businesses merged or consolidated during 1980. Without these acquisitions, which are listed in Note 5 to the financial statements, the revenue increase would have been 15.9%. The balance of revenue increase was due to increased client spending, new assignments from existing clients and new business.

Salaries and employee benefits increased 20.2% from $84,878,460 to $102,004,581. Approximately $3,900,000 of this increase is due to businesses merged or consolidated during 1980. Without these acquisitions the increase in salaries and benefits would have been 15.6%. The remainder of the increase in salaries is due to the addition of approximately 150 employees as a result of internal growth as well as normal increases in salary rates. Employee benefits were higher partly because of increased profit sharing and incentive plan expenses which are functions of the higher profit base and higher salary base. Payroll taxes are also up due to a combination of higher rates and a larger salary base.

Office and general expenses increased 21.6% or slightly more than the increase in revenues or salaries and employee benefits. This expense category has been particularly affected by continued worldwide inflation and increased client service expenditures as a result of the increased volume.

Other income increased $1,141,741 in 1980. The improvement results from increased discounts earned, primarily in the Company's foreign subsidiaries and other income of units newly included in the consolidation.

Equity in earnings of affiliated companies increased from $270,258 to $505,422 primarily due to inclusion of Uniconsult (Berlin) earnings for the first time, together with an improvement in operating results of the other entities included in this category.

## Restatement

Results for 1979, 1980 and 1981 have been restated as the result of the issuance in December, 1981 of a Financial Accounting Standards Board statement revising the accounting requirements for translation of foreign currency. The Company has elected to adopt the new requirements effective January 1, 1981, and has restated the first three quarters of 1981 and comparable prior year periods accordingly. The effect of this restatement is to exclude from the income statement any gains or losses resulting strictly from currency translation of the Company's investment in foreign subsidiaries.

In addition to the above, results for 1979 and 1980 have been restated to comply with a Statement of Financial Accounting Standards regarding the accounting for compensated absences (vacations).

## Extraordinary Gain

During 1979 the Company sold a total of 253,000 shares of its investment in Tele-Communications, Inc. (TCI) stock for an extraordinary gain of $3,296,000 (net of applicable income taxes of $1,500,000) or $1.26 per share.

## Liquidity and Capital Resources

The ratio of current assets to current liabilities remained unchanged at 1.3 to 1 at the end of 1979, 1980 and 1981. However, within current assets, the amount of cash and marketable securities increased significantly from 1980 to 1981 due to improvements in the collection of accounts receivable.

Acquisitions of subsidiary and affiliated companies have been and will likely continue to be a significant capital requirement. Over the past three years, funds needed for acquisitions have been provided by income from operations, issuance of debt and issuance of FCB Common Stock. It is probable that combinations of all these sources will be utilized to finance future acquisitions.

The Company had $19,000,000 in available credit at the end of 1981 under short-term borrowing arrangements with banks, of which $17,700,000 was not utilized. The credit lines are utilized primarily by the Company's foreign subsidiaries. While normal operating conditions from time to time may require various units to utilize their available credit lines, the Company believes there will not be a significant increase in the overall amount of short-term borrowings during 1982.

Other than acquisitions and the short-term requirements referred to above, the Company believes that its cash flow from operations will be adequate to finance the remaining capital requirements.

Effect of Inflation

Inflation has become a significant factor in our economy and the Company is continually seeking ways to cope with its impact. The principal source of the Company's revenues is commissions earned on advertising placed with the various media. As a result, our revenues are based upon our clients' level of advertising expenditures. These expenditures are entirely at the discretion of our clients and do not necessarily increase with inflation. Thus, although media inflation has generally increased as fast or faster than the general inflationary rate, it is impossible for the Company to determine with any precision how much of our volume growth is attributable to inflation.

The ratio of pretax profit to revenues was 13.0% in 1981 compared to 13.6% in 1980 and 13.8% in 1979. This decline in profit ratio is due in part to discretionary client advertising expenditures not keeping pace with our costs which are increasing due to inflationary pressures.

In recent years both the Securities and Exchange Commission and the Financial Accounting Standards Board have issued guidelines for reporting price level adjusted financial information. The Company is not subject to these disclosure requirements. However, because all significant revenues and costs included in the Company's income statement represent current dollar values, the Company's statement of income does not differ materially from the "current cost" statements as recommended by the Financial Accounting Standards Board.

## AGRICULTURE

ALICO INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

(This analysis should be read in conjunction with the financial statements, notes thereto and Letter to Shareholders.)

Liquidity and Capital Resources

Cash flow from the Company's normal operations and the sale of lands, which in the judgment of the management is surplus to these operations, has been adequate to maintain an expanded capital improvement program. Working capital has steadily increased from $2,662,000 at August 31, 1978 to $6,018,000 at August 31, 1981, although net income has declined from $5,509,000 to $4,038,000 during this same period. At August 31, 1981, the Company had cash and temporary cash investments of $4,532,061. The ratio of current assets to current liabilities at August 31, 1981 was 4.93 to 1.

The Company has not incurred any long-term debt since 1974. At August 31, 1981, the balance of this debt including payments due within one year was $1,710,019 which is payable over a period of 34 years. At present, there are no plans to sell securities or incur additional long-term debt to finance future capital improvements or operations.

The largest single capital improvement expected to be made during the next two years is the planting of approximately 2,000 acres of citrus which will cost an estimated $3,000,000.

Results of Operations

The Company's primary operations are in the field of agriculture and, therefore, its income and expenses, in addition to being subject to fluctuations in the market place, are greatly influenced by weather conditions. The freezes during the past two years caused a reduction in the citrus crop which resulted in higher prices. Also, for the past several years, below normal rainfall has adversely affected citrus groves and cattle pastures, resulting in higher operating cost than under normal conditions. This was especially critical in 1981.

During the three fiscal years ending August 31, 1979, 1980 and 1981, total revenues declined from $17,231,032 in 1979 to $15,271,766 in 1980 to $14,554,525 in 1981. For the same period costs and expenses increased from $7,807,995 in 1979 to $8,175,366 in 1980 and decreased to $8,047,445 in 1981. Net income decreased from $5,353,702 in 1979 to $4,238,085 in 1980 to $4,038,213 in 1981.

The profitability by segments before income taxes, and exclusive of operations of the Company's wholly owned subsidiary, Saddlebag Lake Resorts, Inc., for the three years ended August 31, 1981 is presented in the following table:

## OPERATING PROFIT (BEFORE INCOME TAXES) BY DIVISION

| | 1981 | 1980 | 1979 |
|---|---|---|---|
| CITRUS | | | |
| Revenues (Sales): | $7,037,288 | $7,919,972 | $9,429,179 |
| Less Harvesting & Marketing Expense | 1,759,484 | 2,058,128 | 2,369,508 |
| Net Sales | 5,277,804 | 5,861,844 | 7,059,671 |
| Cost and Expenses: | | | |
| Direct Production** | 1,755,850 | 1,392,249 | 1,195,494 |
| Allocated Cost* | 408,258 | 381,208 | 301,909 |
| Total | 2,164,108 | 1,773,457 | 1,497,403 |
| Gross Profit | 3,113,696 | 4,088,387 | 5,562,268 |
| RANCH | | | |
| Revenues: | | | |
| Cattle Sales | 3,214,834 | 2,982,686 | 3,645,425 |
| Less Book Value of Cattle Sold and Sales Expense | 1,042,611 | 1,354,913 | 1,477,780 |
| Net Cattle Sales | 2,172,223 | 1,627,773 | 2,167,645 |
| Other Revenues (Contract Feeding Fees, Crop Sales, etc.) | 168,516 | 242,999 | 325,670 |
| Total | 2,340,739 | 1,870,772 | 2,493,315 |
| Cost and Expenses: | | | |
| Direct Production | 1,460,810 | 1,409,923 | 983,600 |
| Allocated* | 430,360 | 403,934 | 264,447 |
| Total | 1,891,170 | 1,813,857 | 1,248,047 |
| Gross Profit | 449,569 | 56,915 | 1,245,268 |
| FORESTRY | | | |
| Revenues: | 100,808 | 74,559 | 81,964 |
| Cost and Expenses: | | | |
| Direct Production | 48,347 | 40,207 | 52,459 |
| Allocated* | 54,092 | 42,238 | 23,751 |
| Total | 102,439 | 82,445 | 76,210 |
| Gross Profit | (1,631) | (7,886) | 5,754 |
| Total Gross Profit, Agriculture | $3,561,634 | $4,137,416 | $6,813,290 |

Operating Profit (before income taxes) by Division

| | 1981 | 1980 | 1979 |
|---|---|---|---|
| OTHER OPERATIONS | | | |
| Revenues: | | | |
| Oil Leases and Land Rentals | 535,194 | 219,847 | 276,584 |
| Rock Products and Sand | 1,288,970 | 1,076,895 | 870,634 |
| Miscellaneous | 61,927 | 101,048 | 5,445 |
| Total | 1,886,091 | 1,397,790 | 1,152,663 |
| Cost and Expenses: | | | |
| Direct Production | 645,285 | 540,803 | 486,308 |
| Allocated* | 232,469 | 226,441 | 201,920 |
| Total | 877,754 | 767,244 | 688,228 |
| Gross Profit—Other | 1,008,337 | 630,546 | 464,435 |
| GROSS PROFIT FROM OPERATIONS | 4,569,971 | 4,767,962 | 7,277,725 |

| | | | |
|---|---|---|---|
| INTEREST | | | |
| Revenue: | 1,242,525 | 1,101,234 | 1,016,325 |
| Expense: | 209,879 | 325,323 | 450,819 |
| GROSS PROFIT FROM INTEREST | 1,032,646 | 775,911 | 565,506 |
| PROFIT ON SALE OF REAL ESTATE | 904,463 | 1,552,527 | 1,579,806 |
| TOTAL GROSS PROFIT BEFORE INCOME TAXES | $6,507,080 | $7,096,400 | $9,423,037 |

*Allocated expense includes ad valorem and payroll taxes, depreciation, and insurance.
**Does not include maintenance cost of groves less than five years of age consisting of $249,081 on 894 acres in 1981, $148,647 on 761 acres in 1980 and $79,654 on 478 acres in 1979. These costs were capitalized in accordance with Federal income tax regulations.

Citrus

The Company's producing groves (5 years and older), totaling 3,522 acres shown in the table below have not changed appreciably in the past five years. However, principally because of adverse weather conditions in the past two years, production declined from a peak of 1,587,509 boxes in 1978-79 season to 1,502,506 boxes in 1979-80 season to 1,243,062 boxes in the 1980-81 season. While per unit price increased, it was not sufficient to offset decrease in production and increased maintenance cost. The continual increase in the cost of labor, fertilizer, pesticide, fuel and other materials adversely affected cost. In 1981, an intensified tree replacement program also added to the cost of the groves.

ACREAGE BY VARIETY AND AGE

| VARIETY | 0-1 | 1-2 | 3-4 | 8-9 | 16-17 | 18-19 | 20 + | Acres |
|---|---|---|---|---|---|---|---|---|
| Early: | | | | | | | | |
| Hamlin Oranges | 62 | 119 | 88 | — | 210 | 15 | 1,007 | 1,501 |
| Red Grapefruit | — | 40 | 214 | — | — | — | 76 | 330 |
| White Grapefruit | — | — | — | 23 | — | — | — | 23 |
| Tangelos | — | — | — | — | 37 | 44 | 105 | 186 |
| Navel Oranges | 28 | 58 | 34 | — | — | — | — | 120 |
| Mid Season: | | | | | | | | |
| Pineapple Oranges | — | — | — | — | 184 | 97 | 557 | 838 |
| Queen Oranges | — | — | — | — | — | 6 | 45 | 51 |
| Murcott | — | — | 142 | — | — | — | — | 142 |
| Late: | | | | | | | | |
| Valencia Oranges | 15 | 94 | — | — | 169 | 200 | 747 | 1,225 |
| TOTALS | 105 | 311 | 478 | 23 | 600 | 362 | 2,537 | 4,416 |

Ranching

While a larger number of cattle were sold in 1981 than in 1979 or 1980, prices were much lower. Additionally, most of the cattle sold in 1979 and 1980 were finished cattle from the Georgia feedlot, which was discontinued in October 1980. The cattle sold in 1981 were primarily calves and culls from the breeding herd. A large portion of the calves sold in 1981, would ordinarily have been shipped to the Georgia feedlot and sold in fiscal year ending August 31, 1982, thus the income stream from cattle sales was advanced. During 1981 the Company continued its intensified pasture maintenance program, increasing cost above normal. In each of the fiscal years, 1979, 1980 and 1981, per unit cost of fertilizer, labor and other expenses increased.

Forestry

The volume of forest products sold increased in 1981 over 1979 and 1980 at slightly higher prices; however, the cost of management increased.

### Other Operations

Revenues from oil leases and land rentals increased in 1981 primarily because of a larger acreage under lease at higher rates. The decline in 1980 from 1979 was due to a reduction in acreage under lease. Royalties from rock products and sand steadily increased because of a larger volume of materials mined and higher per unit royalty rates.

Direct and allocated expenses charged to other operations include general administrative and other cost not charged to citrus, ranching or forestry.

### Interest

Interest income is generated from temporary cash investments and from mortgage notes held on real estate sold on the installment basis in past years. In 1981, temporary investments of cash at very favorable interest rates have helped offset the decline in the total dollar amount of mortgage notes which are at relatively low interest rates. Interest expense has steadily declined as debt and other long-term obligations such as deferred real estate sales commissions have been reduced.

### Profit on Sale of Real Estate

Revenues from this source may vary greatly from year to year since the Company's long-term policy is to dispose of only those properties classified as surplus to its needs. During the past three years very few sales were made. Therefore, the revenue was largely from the recognition of deferred profit on sales in prior years (See Note 2 of Notes to Financial Statements).

### Impact of Inflation

The effect of inflation is a serious matter which must be considered in all phases of the Company's operations. The cost of labor, materials, and replacement of machinery and equipment, which are all necessary in carrying on the Company's primary operations continue to increase at a much more rapid pace than the price of products produced and sold by the Company. Due to the nature of the Company's primary operations (agriculture), the Company has very little control over the prices received for its products, therefore, cannot pass on the increased cost of production to its customers.

## BANKING

### FAR WEST FINANCIAL CORPORATION

*Management Discussion and Analysis of the Financial Condition and the Results of Operations*

### Liquidity and Capital Resources

The principal business of Far West Financial Corporation (Far West) is conducted through its wholly-owned subsidiary Far West Savings and Loan Association. The standard measure of liquidity for the savings and loan industry is the ratio of cash and eligible investments to the sum of net withdrawable savings and borrowings due within one year. The minimum required level is currently set by regulation of the Federal Home Loan Bank Board at 5%. Far West, as a matter of policy, sets a target liquidity level in excess of this requirement.

The liquidity position of Far West, measured at a point in time, was 6.4% at December 31, 1981 compared to 6.5% and 11.3% at the end of 1980 and 1979 respectively. However, during 1981 the average balance in earning liquid securities was significantly higher than the closing ratio. This coupled with record high short-term interest rates resulted in increased income from investments over both 1980 and 1979.

The primary sources of funds for Far West include savings deposits, borrowings from the Federal Home Loan Bank, loan repayments and sales and proceeds from real estate sales. In addition, Far West initiated a repurchase agreement program with its customers in December 1981, providing the Company with the ability to raise funds in minimum amounts of $500 for terms ranging up to 89 days.

To improve the short-term borrowing capacity of Far West, in early 1982 approximately $100 million in older low interest rate loans were traded in a like kind exchange for loan participation certificates issued by the Federal Home Loan Mortgage Corporation (an agency of the U.S. Government). These certificates can be used as collateral for both the retail repurchase program mentioned above and other forms of short-term borrowings more effectively than the individual loans or packages of loans themselves. Other sources of funds which are available, but are used more sparingly depending upon economic conditions, include the issuance of mortgage-backed bonds and commercial bank credit lines. At December 31, 1981 the outstanding available commercial bank credit line was $25 million.

Historically, loan prepayments have been a significant source of new funds for Far West. The *Wellenkamp* decision of the California Supreme Court, however, has essentially eliminated the ability of Far West to exercise the due on sale clause in its loans when property is sold. This results in lengthening the average life of older loans, which also has the effect of preventing Far West from increasing its loan portfolio yield by rewriting older loans at current rates as properties are sold. Until the California Legislature sees fit to pass remedial legislation, *Wellenkamp* will continue to reduce lendable funds available to support the growing demand for housing in California as well as to exacerbate the imbalance between loan yields and savings costs discussed below.

Additionally, the mix of the sources of funds used by Far West is in large part a function of prevailing interest rates. During this period of record high interest rates, more borrowers have chosen to retain their older, lower interest rate loans rather than pay them off or refinance at higher rates. Higher rates, coupled with the effect of *Wellenkamp*, have induced purchasers of property to indulge in so-called "creative financing" whereby the existing lower rate loan is supplemented with short-term secondary financing. Loan prepayments, which amounted to $43.1 million in 1979 and $43.6 million in 1980, dipped to $27.4 million in 1981, reflecting the above factors as well as the generally depressed state of the California real estate market due to high interest rates experienced during 1981.

Reduced loan volume, together with the fact that profitable loan sales are restricted to the more recent current market rate loan originations, affected the volume of loan sales. Loan sales as a source of funds amounting to $50.8 million in 1979 and $72.2 million in 1980, dropped to $33.1 million in 1981.

Savings deposits improved significantly during 1981 over 1979 and 1980. The net cash increase in savings (exclusive of interest credited) was $66.2 million in 1981, $10.7 million in 1980 and $21.6 million in 1979. Net savings inflows have and will continue to be an important source of funds for lending and other investment activities in the future. However, savings as a source of funds has become more costly as the majority of funds provided from this source are from interest rate-sensitive six-month and 30-month certificates tied to U.S. Treasury borrowing rates and $100,000 Certificates of Deposit. The shift in the mix of savings deposits to market rate-sensitive accounts and the effect on the cost of savings is illustrated by the following table:

| | Percent of Total Savings | | |
|---|---|---|---|
| | December 31, | | |
| | 1981 | 1980 | 1979 |
| Passbook and fixed rate certificates | 20.8% | 33.3% | 52.1% |
| Interest rate-sensitive accounts | 79.2% | 66.7% | 47.9% |
| | 100.0% | 100.0% | 100.0% |
| Weighted Average Cost | 13.15% | 10.32% | 8.66% |

With the passage of the Deregulation and Monetary Control Act of 1980, the trend in the mix of savings will continue in favor of rate-sensitive savings instruments. Current rate controls and the rate differential in favor of savings and loan associations over banks on some accounts, are expected to be completely phased out over the next five years under provisions of this Act. This will place all depository institutions in the same competitive position as to rates being offered for savings type investments.

During 1982, Far West expects to use a mix of capital resources similar to that of 1981 to meet its ongoing commitments to fund maturing savings certificates, repay borrowings due within a year, fund existing and continuing loan commitments and continue with its real estate investment and branch improvement programs. At December 31, 1981, the total of approved loan commitments amounted to $13.6 million. Scheduled repayments of Federal Home Loan Bank advances and mortgage-backed bonds during 1982 total $32.1 million. There were no material commitments for capital expenditures at the end of 1981. It is anticipated that the foregoing funding requirements can be met with loan repayments and sales, savings and normal levels of borrowings.

## Results of Operations

### Income Items

Far West's gross income increased $26.4 million or 29.5% over 1980. This increase exceeds the $12.0 million or 15% increase in 1980 over 1979. As in prior years, the major item contributing to the increase in total income was interest on loans. Not only has the overall loan portfolio grown in absolute terms, the average yield has increased from 9.94% at December 31, 1979 to 10.90% at December 31, 1980, to its current average yield of 11.57% at December 31, 1981. This steady increase is the result of adding loans at increasingly higher interest rates during the three year period ended December 31, 1981. The average yield on new loans originated during 1981 was 18.25% compared to 13.82% and 12.03% during 1980 and 1979 respectively.

New loans originated during 1981 were down in volume from both 1980 and 1979 levels; however the types of loans made generated greater loan fee income per loan than in 1980 and 1979. In an effort to more closely match the yields and terms on savings deposits, greater emphasis has been placed on construction loans and short-term equity loans which carry higher interest rates and command higher loan origination fees. As a result, loan origination fee income increased $0.9 million or 29% in 1981 over 1980. Loan fee income was relatively stable in the prior two years.

Other loan fees, including fees for loan prepayment penalties, late charges and loan commitments declined in 1981, resulting primarily from the decrease in loan prepayment penalty income. As discussed under the heading of "Liquidity and Capital Resources", loan prepayments as a source of funds suffered from the impact of the *Wellenkamp* decision and higher mortgage rates.

Income from investments increased substantially over both 1980 and 1979. In the discussion of "Liquidity and Capital Resources", it was noted that short-term interest rates were at all-time highs during 1981. As a result, income from investments increased $6.4 million or 102% over 1980. The variation between 1979 and 1980 is also attributable to a combination of rates and liquidity levels maintained during those years.

Income from real estate operations in 1981 increased 21.5% over 1980 compared to a 38% decrease in 1980 from 1979. As previously mentioned, in both 1981 and 1980 the real estate market was generally depressed as a result of higher mortgage interest rates.

An extraordinary item which contributed to an after tax increase in income was the result of taking advantage of a market opportunity to retire $9 million of mortgage-backed bonds prior to maturity. Far West also received a California Franchise Tax refund from prior years amounting to $450,000, which is included in other income.

### Expense Items

Total interest expense in 1981 increased 58% over 1980. This compares to a 36% increase in 1980 over 1979. Savings interest expense as a percentage of total income was 77.6% compared to 66.4% in 1980 and 57.2% in 1979. As illustrated in the table on page 6, the increase in the cost of savings is due to the shift in the mix of savings deposits from passbook and fixed-rate certificates to interest rate-sensitive $100,000 Certificates of Deposit and Money-Market Certificates during a period when short-term interest rates were at historical highs.

General and administrative expenses rose only slightly during 1981. As a percentage of total income, general and administrative expenses fell to 13.0% compared to 16.8% in 1980 and 17.6% in 1979. Far West intends to continue to exercise budgetary controls in this area during 1982.

Federal and state income taxes (benefit) are computed using the appropriate effective tax rate after deducting the allowable additions to reserves for bad debts provided by law. The 1981 taxable loss differs substantially from the loss reported in the financial statements due to various timing differences in recognizing income and expense items for tax purposes. The 1981 tax loss will be carried back to prior years' tax returns and will result in a recovery of approximately $4.5 million in prior year taxes. (See Note 9 to the accompanying financial statements).

### Net Income (Loss)

The reported loss for 1981 of $3.9 million is the result of two primary factors which are essentially both related to general economic conditions beyond the direct control of Far West. The sustained rise in interest rates coupled with the change in the savings mix to interest rate-sensitive accounts caused a sharp increase in the cost of savings. Despite the increase in the overall yield on the loan portfolio and increased income from both liquid investments and real estate operations, the same rate of increase could not be achieved on Far West's loan portfolio because of the existence of long-term fixed-rate loans which do not adjust to current market rates as fast as rates go up on the savings side.

## COMPUTER AND OTHER DATA PROCESS SERVICES

CACI, INC./CACI N.V.

*Managements' Discussion and Analysis of Financial Condition and Results of Operations*

The following discussion has been limited to the combined results of CACI, Inc., CACI N.V., and their respective subsidiaries, inasmuch as CACI N.V. was an inactive corporation until March, 1981. CACI N.V. was organized to provide services consisting primarily of the application of analysis and computer software techniques to the solution of managerial and operational problems of business and governmental customers, particularly in Western Europe.

Results of Operations

Combined revenue increased 63 percent in fiscal 1982, as compared to a 68 percent increase in fiscal 1981 and a 76 percent increase in fiscal 1980. This growth in revenue has resulted primarily from increased levels of business activity with existing customers in all major areas of the corporations' activities.

Total costs and expenses were 93 percent of revenue in 1982, 1981, and 1980. Direct costs were 44 percent of revenue in 1982, compared to 41 percent of revenue in 1981 and 1980. Indirect costs and selling expenses decreased to 46 percent of revenue in 1982 from 50 percent of revenue in 1981 and 1980. This relative decrease in indirect costs reflects more efficient utilization of personnel and other resources on contract activities. Interest expense increased approximately $120,000 in 1982, $481,000 in 1981, and $53,000 in 1980, reflecting higher levels of short-term borrowing and ascending interest rates. Weighted average interest rates were approximately 18 percent in 1982, 16 percent in 1981, and 15 percent in 1980.

The combination of the above factors produced increases in pretax earnings of 70 percent in 1982, 65 percent in 1981, and 9 percent in 1980. The nature of the corporations' operational activities is not expected to result in significant changes in the recent historical relationships between revenue and costs.

The effective tax rate was 35 percent of pretax earnings in 1982, 42 percent in 1981, and 44 percent in 1980. The reduction in the effective tax rate in 1982 reflects increased business levels in geographical areas with lower tax rates and investment tax credits on equipment and facilities which were put into service during the year. Through effective tax planning, the corporations have been able to defer the payment of most of their taxes during this three-year period, thereby minimizing cash payments. This trend is expected to continue for the next several years.

Consistent with increases in revenue and expenses, net income increased approximately 92 percent in 1982, 70 percent in 1981, and 9 percent in 1980. Net income as a percentage of revenue was 5 percent in 1982 and 4 percent in 1981 and 1980.

Liquidity and Capital Resources

The current asset/current liability ratio increased to 1.13 in 1982 from 1.05 and 1.10 in 1981 and 1980, respectively. The 1982 increase is due primarily to increased accounts receivable related to revenue growth. The 1981 and 1980 decreases reflect (i) additions to property and equipment, funded by current debt, related to the expansion of business locations and significant revenue growth, and (ii) increasing amounts of income tax liability. Working capital increased to $2,733,285 in 1982 from $747,543 and $937,745 in 1981 and 1980, respectively.

The ratio of current assets to current liabilities, net of the current portion of deferred taxes, was 1.43 in 1982, compared to 1.32 and 1.33 in 1981 and 1980, respectively.

Continued emphasis by the managements of the corporations on current collection policies resulted in accounts receivable turnovers of 8.7 times in 1982, 7.4 times in 1981, and 6.1 times in 1980.

The corporations' long-term efforts to internally generate all funds necessary for increases in property and equipment as well as the expansion of European operations required bank borrowings beginning in the last quarter of 1980 and continuing through 1982, reaching a new successive high at each fiscal year end. Primarily as a result of increased earnings, the fiscal year end debt to debt-plus-equity ratio decreased to 36 percent in 1982, compared to 44 and 35 percent in 1981 and 1980, respectively.

The corporations expect continued growth to be financed from bank lines of credit, continued high receivable turnover, and net profits.

Information About CACI Shares

Since March 2, 1981, the common shares of CACI, Inc. and units of beneficial interests in the shares of CACI N.V. have traded only in tandem as a "paired unit" in the United States in the over-the-counter market. Each paired unit consists of one common share of CACI, Inc. and beneficial interests in one common share of CACI N.V. These units are quoted on the NASDAQ, the National Association of Securities Dealers' Automatic Quotation system, under the symbol "CACI."

The average bid and asked prices of CACI units (which prior to March 2, 1981, consisted solely of CACI, Inc. shares) for each quarterly period during the two most recent fiscal years are as follows:

| Fiscal 1982 | | | Fiscal 1981 | | |
|---|---|---|---|---|---|
| Quarter | Bid | Asked | Quarter | Bid | Asked |
| 1st | $23.08 | $24.29 | 1st | $18.68 | $19.67 |
| 2nd | 28.62 | 29.50 | 2nd | 23.81 | 24.82 |
| 3rd | 33.67 | 34.96 | 3rd | 21.41 | 22.57 |
| 4th | 41.16 | 42.04 | 4th | 19.84 | 21.15 |

The bid and asked prices reflect inter-dealer prices, without retail mark-up, mark-down, or commission, and may not necessarily represent actual transactions. These prices do not reflect the proposed 200% stock dividend described in Note 11, Subsequent Events, of the Notes to Financial Statements.

CACI declared and paid a dividend to holders of CACI common shares as of the close of business on February 27, 1981, a dividend in kind consisting of the beneficial interests in one common share of CACI N.V. for each common share of CACI, Inc. held. In the opinion of Wachtel & Co., Inc., stockbrokers, underwriters, and appraisers of stock values, the value of the dividend was $.003 per share. No other dividend has been either declared or paid by either CACI, Inc. or CACI N.V. during the two fiscal years ended June 30, 1982.

## CONTRACT CONSTRUCTION

### REXCO INDUSTRIES, INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Summary

The following table sets forth for the periods indicated (i) percentages which certain items reflected in the financial data bear to net sales of the Company (ii) gross profit percentages of each revenue classification and (iii) the percentage increase of such items as compared to the indicated prior year:

| | Relation to Total Revenues Year Ended September 30, | | | Period to Period Increase (Decrease) | |
|---|---|---|---|---|---|
| | 1981 | 1980 | 1979 | 1979-80 | 1980-81 |
| Revenues: | | | | | |
| Contracts— | 86.7% | 80.4% | 80.3% | 16.2% | 11.6% |
| Gross profit | 1.1 | 4.6 | 4.3 | 24.7 | ( 72.4) |
| Sales properties and products— | 7.7 | 16.7 | 16.8 | 15.5 | ( 52.4) |
| Gross profit | 1.6 | 3.9 | 3.7 | 11.1 | ( 21.0) |
| Rental properties— | 2.5 | 2.3 | 2.5 | 7.5 | 15.8 |
| Gross profit | 24.7 | 27.3 | 30.0 | (2.2) | 4.9 |
| Other income | 3.1 | .6 | .4 | 53.9 | 470.9 |
| | 100.0 | 100.0 | 100.0 | | |
| Composite gross profit | 4.8 | 5.5 | 5.2 | 21.5 | (9.5) |
| General and administrative expenses | 5.4 | 5.3 | 5.7 | 6.4 | 7.0 |
| Earnings (loss) before income taxes, equity in net earnings of affiliates and extraordinary item | (.6) | .2 | (.5) | 143.5 | (451.5) |
| Income tax provision (benefit) | — | .4 | (.8) | 155.6 | (105.1) |
| Equity in net earnings of affiliates | .7 | .3 | .6 | ( 37.3) | 125.7 |
| Extraordinary item | — | — | .3 | (100.0) | — |
| Net earnings | .1% | .1% | 1.2% | ( 87.2) | ( 40.7) |

## Results of Operations

Revenues from construction contracts continue to be the principal Company's activity, having increased by 86% over the last three years. In spite of the intense competition and the scarcity of new contracts, the Company has been able to maintain a healthy backlog of contract work through successful bidding and negotiations of local public and privately owned industrial projects. The new local contracts have coped with the diminishing contract activity on the Company's foreign sites where work has been substantially completed. Please refer to Note L (Subsequent Event) of the Notes to the Consolidated Financial Statements, which note is incorporated herein by reference.

Gross profits during the fiscal years 1981, 1980 and 1979 have been adversely affected by the losses reported during these fiscal years on the Company's foreign operation contracts, aggregating to approximately $2,900,000, $1,100,000 and $714,000 respectively.

Sales of Properties and Products for 1981 diminished over the levels maintained during 1980 and 1979 principally as a result of completing deliveries at the Company's 622 housing units project during the first quarter of fiscal 1981. This was a subsidized housing project with revenues aggregating to approximately $17,000,000 reported over a 36 months period ending during the first quarter of 1981. The Company is not presently engaged in any selfsponsored residential housing project.

Gross profit from sales of properties and products during fiscal year 1981 was also affected by the non profitability of the Company's aggregates manufacturing subsidiary, adversely affected by a decline in public projects with high requirements for its products.

Revenues from Rental Properties for the periods under consideration have maintained a steady relation with total revenues and increased over the period 1980-81 as a result of accruing for the additional revenues arising out of the cost escalation clauses in two of the lease agreements in effect, allowing for a better relationship between costs and revenues.

Except for fiscal 1981, other income did not represent a significant item in the Company's total revenue. However, during 1981 various pieces of construction equipment were sold producing income of approximately $1,882,000.

The equipment sold was principally related with earth moving work which projects are not abundant in the Company's present backlog of work. The Company continues its efforts to dispose of most of this and other types of idle construction equipment during the coming fiscal year 1982.

## General and Administrative Expenses

Although general and administrative expenses have maintained a very similar relationship with total revenues over the three fiscal years ended 1981, these have shown an upward trend in line with the trend in total revenues over the same period. This increase is principally attributed to the normal increase in payroll and related costs coupled with the inflationary trend of the cost of obtaining goods and services and the interest expense.

## Income Tax Provision (Benefit)

The composition as to the nature and amounts of the items making up the provision for income taxes (benefit) is disclosed on Note F of the Notes to Consolidated Financial Statements for the three years ended September 30, 1981, which note is herein incorporated by reference.

## Equity in Net Earnings of Affiliates

Due to the marginal earnings before the equity in net earnings of affiliates, this line item have [sic] played an important role in the consolidated net earnings for all the periods presented. Please refer to Note C of the notes to the Consolidated Financial Statements, which note is incorporated herein by reference.

## Net Earnings

In summary, net earnings for the three fiscal years ended September 30, 1981 have been seriously affected by the losses sustained by the Company's foreign operations. However, having substantially completed all foreign contracts and accrued for all estimated losses, fiscal 1982 should result in a more profitable year.

## Liquidity and Capital Resources

The Company's working capital for the three years ended September 30, 1981 were the following:

| | (In thousands) | | | Increase (Decrease) | |
|---|---|---|---|---|---|
| | 1981 | 1980 | 1979 | 1979-80 | 1980-81 |
| Working capital | $6,531 | $8,070 | $6,695 | $1,375 | $(1,539) |
| Working capital ratio | 1.25:1 | 1.34:1 | 1.31:1 | .03 | ( .09) |

Although the Company's working capital has been impaired by the significant losses incurred by and the cash advances made to the foreign operations, actually, the liquidity of the Company has improved as a result of the cash flow generated by various private industrial projects presently under construction and from cash dividends received from affiliated companies. Changes in cash and short-term cash investments are presented in the Consolidated Statements of Changes in Financial Position.

As of the end of each of the three fiscal years ended September 30, 1981 the Company had the following unused lines of credit.

| | |
|---|---|
| 1981 | $3,900,000 |
| 1980 | 3,200,000 |
| 1979 | 2,200,000 |

There were no balances due on the available lines of credit as of September 30, 1981.

At the present time the Company does not plan to borrow additional long-term funds, sell securities or enter into any material financing arrangements. There are no commitments for significant capital expenditures, nor are any significant changes in the mix and relative cost of capital resources expected within the foreseeable future.

## ELECTRIC SERVICES

### SOUTHERN CALIFORNIA EDISON COMPANY

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Results of Operations

The Company's results of operations for 1981 were favorably affected by a decision, effective January 1, 1981, from the California Public Utilities Commission (CPUC) which authorized a general rate increase of $294 million annually. In addition, the decision provided for an attrition allowance to help meet inflation-related cost increases which have been a primary cause of fluctuations in net income between rate cases. The attrition allowance was implemented on January 1, 1982, and increased base rates by $92 million annually.

The following table presents amounts and percentages of increase (decrease) in the rate components of operating revenues from the prior years.

| Increase (Decrease) from Prior Years | Millions of Dollars 1981 | % | 1980 | % | 1979 | % |
|---|---|---|---|---|---|---|
| Operating Revenues: | | | | | | |
| Energy Cost Adjustment Clause | $ (19) | (0.9) | $ 973 | 80.6 | $ 75 | 6.6 |
| Annual Energy Rate | 32 | — | — | — | — | — |
| Base Rates | 280 | 23.3 | 31 | 2.6 | 153 | 15.1 |
| Resale & Special Contracts | 102 | 41.5 | 74 | 43.0 | 30 | 21.0 |
| Other Electric Revenue | (2) | (6.5) | 19 | 174.2 | (23) | (68.3) |
| Total Operating Revenues | $ 393 | 10.7 | $1,097 | 42.8 | $ 235 | 10.1 |
| KWH Sales (Millions) | 2,536 | 4.2 | 397 | 0.7 | 2,491 | 4.4 |
| Customers | 68,719 | 2.2 | 81,586 | 2.6 | 95,837 | 3.2 |

For 1981, total operating revenues increased as a result of the net effect of the general rate increase, increased sales to other utilities, an annual energy rate which became effective on October 25, 1981, and lower energy cost adjustment clause revenues which are offset by energy costs and do not affect earnings. Kilowatt-hour sales increased 4.2% for 1981 primarily as a result of unusually high temperatures experienced in Southern California in the third quarter and increased sales to other utilities.

The following table presents amounts and percentages of increase (decrease) from the prior years in selected items from the Statements of Income.

| Increase (Decrease) from Prior Years | Millions of Dollars, Except Earnings Per Share Data | | | | | |
|---|---|---|---|---|---|---|
| | 1981 | % | 1980 | % | 1979 | % |
| Other Operation Expenses | $ 49 | 12.6 | $ 70 | 21.9 | $ 39 | 13.6 |
| Maintenance Expense | (35) | (15.3) | 51 | 28.7 | 13 | 8.1 |
| Taxes on Income | 159 | (a) | (62) | (61.4) | 27 | 37.8 |
| Total Interest Charges | 58 | 20.6 | 78 | 37.8 | 22 | 12.3 |
| Allowance for Debt and Equity Funds Used During Construction | 70 | 43.3 | 44 | 36.9 | 40 | 51.2 |
| Net Income | 172 | 54.3 | (29) | (8.3) | 95 | 37.6 |
| Earnings Available for Common and Original Preferred Stock | 165 | 64.5 | (36) | (12.3) | 90 | 44.6 |
| Earnings Per Share | 1.43 | 40.9 | (1.06) | (23.2) | 1.04 | 29.5 |
| Weighted Average Number of Shares (Millions) | 12 | 16.9 | 9 | 14.1 | 7 | 11.7 |

(a) Indicates over 200%.

Increases in other operation expenses continue to be due to system growth and to the impact of inflation on the costs of labor, material and services. The Company, however, is continuing its efforts to alleviate the impact of inflation on these expenses with continued emphasis on productivity and cost controls.

Maintenance expense reflects the impact of inflation as well as varying weather conditions. The comparative decreases for 1981 are principally the result of the large maintenance expenditures which were incurred in 1980 at the Mohave and San Onofre (Unit 1) Generating Stations.

Taxes on income for 1981 increased over 1980 primarily as a result of increased pre-tax net income. Additionally, income taxes increased because of adjustments to pre-tax income, including the loss, due to recent Federal legislation, of the percentage repair allowance deduction for periods after 1980.

The Company's reported net income reflects, in addition to the items discussed above, the impact of higher interest charges which were due to additional short- and long-term debt outstanding and higher interest rates. The additional indebtedness was incurred by the Company primarily in connection with its continuing construction program, which is also responsible for the increasing levels of the non-cash allowance for debt and equity funds used during construction.

Earnings available for common and original preferred stock were affected by the additional dividend requirements of a series of $100 cumulative preferred stock issued in October 1980 and two series of $100 cumulative preferred stock issued in 1979. Earnings per share have been impacted by the dilutive effect of an increasing number of outstanding shares of Common Stock sold to help finance the Company's continuing construction program.

A discussion relating to supplementary information to disclose the effects of changing prices follows the "Notes to Financial Statements" on page 29 of this report.

### Liquidity

Liquidity refers to the ability of a company to generate funds, whether from operations, long-term financings or other sources, adequate to meet its needs. The following table provides a summary of the Company's sources of funds used for construction expenditures for the years 1981, 1980 and 1979.

| | Millions of Dollars | | |
|---|---|---|---|
| | 1981 | 1980 | 1979 |
| Funds Provided by Operations—Reinvested | $174 | $125 | $238 |
| Funds Provided by Long-term Financing—net | 800 | 533 | 446 |
| Other Sources (Uses) of Funds | (17) | 124 | (10) |
| Funds Used for Construction | $957 | $782 | $674 |
| Funds Provided by Operations as a Percent of Funds Used for Construction | 18% | 16% | 35% |

The Company is engaged in an extensive construction program designed to accommodate existing and projected demands on its electric system. Because of the high level of construction work in progress primarily related to the construction of San Onofre Units 2 and 3, a significant portion of the Company's net income in recent years has been attributable to the Allowance for Funds Used During Construction (AFUDC), which does not represent current cash income of the Company. AFUDC constituted approximately 47%, 51% and 34% of net income for the years 1981, 1980 and 1979, respectively. AFUDC is expected to decline significantly when San Onofre Units 2 and 3 are placed in service with a resulting reduction in this non-cash portion of net income. Assuming the costs incurred in connection with the construction and operation of these units receive appropriate and timely rate treatment, sufficient revenues are expected to be authorized to offset the decline in AFUDC.

Capital Resources

To provide the funds for construction expenditures for the five years through 1986 estimated to total $4.0 billion and to meet long-term debt maturities and preferred stock sinking fund requirements aggregating $796 million during such years, the Company estimates that approximately $2.9 billion, or 60%, of such expenditures will be provided by long-term financing. The balance of funds required for these purposes is expected to be obtained from operations, primarily during the latter part of such period, with a substantial majority of construction funds in 1982 projected to be obtained from external sources.

The Company's estimates of funds available from operations assume the receipt of adequate and timely rate relief, the timely inclusion of the new San Onofre Units and Palo Verde Units in rate base and the realization of its assumptions regarding cost increases, including the cost of capital. The Company's estimates and underlying assumptions are subject to continuous review and periodic revision.

The timing, type and amount of all additional long-term financing are also influenced by market conditions, rate relief and other factors, including limitations imposed by the Company's Articles of Incorporation and Trust Indenture.

Funds provided by long-term financing after giving effect to the reduction of long-term debt, securities held by trustees and the conversion of preference stock amounted to $800 million in 1981. This reflects pollution control equipment financing bond issues and unsecured debt offerings in the European market, as well as traditional public debt and equity offerings. In addition, the Company uses short-term borrowings as a part of normal daily operations and to meet interim cash needs for capital projects, pending periodic reductions or repayment through long-term financing. The Company has a total of $736 million of available short-term borrowing facilities with foreign and domestic banks. At December 31, 1981, approximately $295 million of such borrowings were outstanding.

The Company's long-term goal is to maintain a capital structure with approximately equal amounts of debt and equity. The Company's capital structure at the end of the years 1981, 1980 and 1979 is shown below:

| | 1981 | 1980 | 1979 |
|---|---|---|---|
| Long-Term Debt | 47.3% | 46.3% | 47.4% |
| Preferred and Preference Stock | 12.0 | 13.9 | 14.1 |
| Common Equity | 40.7 | 39.8 | 38.5 |
| | 100.0% | 100.0% | 100.0% |

Operating Revenues and Kilowatt-Hour Sales

| Class of Service | Operating Revenues (Thousands of Dollars) | | | | Kilowatt-Hour Sales (000) | | | |
|---|---|---|---|---|---|---|---|---|
| | % of 1981 total | 1981 | 1980 | % change | % of 1981 total | 1981 | 1980 | % change |
| Residential | 27.5 | $1,115,758 | $1,026,778 | 8.7 | 26.7 | 16,688,956 | 16,471,840 | 1.3 |
| Agricultural | 1.9 | 75,257 | 68,503 | 9.9 | 1.8 | 1,116,308 | 964,452 | 15.7 |
| Commercial | 26.9 | 1,090,694 | 979,051 | 11.4 | 24.9 | 15,562,087 | 14,778,843 | 5.3 |
| Industrial | 26.2 | 1,063,823 | 997,831 | 6.6 | 27.2 | 17,000,598 | 16,777,563 | 1.3 |
| Public Authorities | 8.2 | 331,972 | 312,578 | 6.2 | 7.5 | 4,667,700 | 4,623,886 | 0.9 |
| Interdepartmental | — | 77 | 51 | 51.1 | — | 1,218 | 1,138 | 7.0 |
| Resale | 6.0 | 244,720 | 198,543 | 23.3 | 7.3 | 4,539,467 | 4,415,038 | 2.8 |
| Subtotal | 96.7 | 3,922,301 | 3,583,335 | 9.5 | 95.4 | 59,576,334 | 58,032,760 | 2.7 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Resale-Special Contracts | 2.5 | 99,240 | 44,631 | 122.4 | 2.6 | 1,639,158 | 1,071,184 | 53.0 |
| Public Authorities-Special | 0.1 | 5,007 | 3,407 | 47.0 | 2.0 | 1,235,827 | 811,243 | 52.3 |
| Total Sales of Electric Energy | 99.3 | 4,026,548 | 3,631,373 | 10.9 | 100.0 | 62,451,319 | 59,915,187 | 4.2 |
| Other Electric Revenues | 0.7 | 27,808 | 29,744 | (6.5) | — | — | — | |
| Total | 100.0 | $4,054,356 | $3,661,117 | 10.7 | 100.0 | 62,451,319 | 59,915,187 | 4.2 |

## INSURANCE

### ALEXANDER & ALEXANDER SERVICES INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Results of Operations

Commissions, fees and other income increased 8.4% in 1981, while net income and earnings per share remained relatively even as compared to the prior year. Increases in total commissions, fees and other income for 1980, 1979 and 1978 were 10.1%, 13.6% and 21.4%, respectively. A similar trend exists in the increase in net income of 5.8% in 1980, 17.7% in 1979 and 26.8% in 1978. This drop in growth is largely the effect of the continued decline in property and casualty premium rates from the peak levels of 1977.

Casualty, property and marine commissions and fees, which comprise over 70% of total revenues, grew at rates of 5.6% in 1981, 7.3% in 1980, 9.7% in 1979 and 19.4% in 1978. Intense competition among the primary insurance companies for underwriting business, brought about by an excess reinsurance capacity and high investment yields, has depressed premium rates resulting in an adverse effect on growth. The effect of these reduced rates was partially offset by the production of new business and by increases in insurable values resulting from the high rate of inflation. Future revenue growth in this area is largely a function of new business production, insurance premium rates and the effects of inflation. Insurance premium rates are cyclical and can vary widely based on insurance market conditions.

In addition to the various business and economic factors affecting the Company's growth, acquisitions have contributed significantly to the expansion of the Company's revenue and net income base in both its insurance brokerage and financial service areas. Reference is made to Note 2 to the financial statements for information concerning the effect of 1981 mergers accounted for as poolings of interests on the Company's results of operations.

As a result of higher short-term interest rates and a more aggressive portfolio management, investment income grew 25.7% in 1981 and 25.2% in 1980. Increases of 60.1% in 1979 and 74.6% in 1978 were the direct effect of higher levels of cash investments and increases in average interest rates. The higher levels of cash investments were due in part to the issuance of commercial paper which permitted funds previously invested in the premium finance subsidiaries to be invested in the short-term money market.

Revenues from human resource management (HRM) and executive planning services consisting principally of life and group, actuarial and employee benefit communications rose 10.7% in 1981, 4.2% in 1980, 9.0% in 1979 and 19.4% in 1978. The group and life area has not been adversely affected by the soft market in the insurance industry. The principal reasons for the increases have been the expansion of services offered, increased service fees and the production of new business. The small rate of growth for 1980 was primarily caused by the sale of the Company's Canadian operations in early 1980, which were mostly HRM.

Premium finance operations continued to grow, though at a lesser rate than its peak of 1979, due primarily to the effect of higher interest rates on premium financing and increased competition in the industry. The growth of property tax consulting is largely the result of the Company's expanded sale of this service and an increase in the size of its operations through acquisitions.

Other income generally consists of management consulting fees, equity in net income of unconsolidated subsidiaries and affiliates and various other operations. Reference is made to Note 7 to the financial statements for information relating to the Company's net equity in its insurance underwriting operations for the last three years. Included in 1981 was approximately $2,130,000 of income from investments in purchased tax benefits as more fully described in Note 4 to the financial statements.

Also, 1980 included the gain of $875,000, before income taxes, on the sale of the Company's interest in its Canadian operations.

Increases in operating expenses, other than interest, are due primarily to higher costs in the area of salaries and employee benefits in order to ensure that the Company remains competitive in the industry, higher levels of business activity and continued inflationary pressures which affected most other categories. The moderating rate of increase for 1981, 1980 and 1979 is primarily the result of expense controls, offset somewhat by costs incurred in connection with the Company's commitment to computer development in the area of risk management. The upsurge in interest expense for all periods since 1978 is due principally to high interest rates and the increased issuance of commercial paper and other short-term borrowings.

Liquidity and Capital Resources

Cash requirements of the Company are met by funds generated from operations and the use of short-term debt and commercial paper. Commercial paper is used principally to provide capital resources for the Premium Finance Division. The Company maintains lines of credit in support of the commercial paper borrowings as described in Note 8 to the financial statements.

In the current year, working capital was used to purchase tax benefits, fund capital additions, and for the acquisition of Alexander Howden Group Ltd. as described in Note 12 to the financial statements. Future working capital requirements will be met by internally generated funds and external borrowings.

Premiums, less commissions allowed the Company, are held in a fiduciary capacity until paid to insurance companies. These premium trust funds are not used to meet the companies' cash needs.

Reference is made to Note 12 to the financial statements for further information concerning the acquisition of the Alexander Howden Group in January of 1982 and the issuance of new equity capital and of 11% convertible subordinated debentures.

## LODGING

### HILTON HOTELS CORPORATION

*Management's Discussion and Analysis of Operations and Financial Condition*

The significant factors influencing operating results and changes in financial strength over the past three years are discussed below. Certain key measures of performance are presented in five-year charts and tables to portray trends in evidence over a longer period.

For additional information concerning Hilton Hotels Corporation's operations and financial position please review the Chairman and President's letter to stockholders, pages two through six, and the information on pages 34 and 35 of this report.

Results of Operations

Revenues

Since 1978, total revenues including revenues of non-consolidated managed hotels have grown by 35 percent to $1.2 billion. Total consolidated revenues have advanced 32 percent in the past three years to $585.2 million in 1981.

During this same period, the occupancy rate of the Company's total properties owned 50 percent or more declined six percentage points from a record high of 73 percent. Under pressure from a stagnant economy, the occupancy of non-Las Vegas hotels has slipped by seven percentage points in the past two years from its high of 71 percent. Occupancy in Hilton's hotel-casinos, though comparatively high at 81 percent in both 1981 and 1980, was down five percentage points from 1978's level.

The trend of lower occupancy has had a significant bearing on total revenues. The resultant decline in hotel revenues, however, has been largely offset by property expansion, additional new managed and franchised hotels and inns, and increased room rates and menu prices.

Revenues from management and franchise fees have continued their strong upward momentum. This revenue source is of growing importance to the Company. Although this sum is a relatively small amount of last years total revenue, a substantial portion flows to income.

Combined management and franchise fees have grown at a compound rate of 20.7 percent annually in the past five years—management fees at 14.9 percent and franchise fees at 28.6 percent. Extensive expansion underway in both areas, as outlined in the Chairman and President's letter to stockholders, assures a continuing source of revenue increases in 1982 and in the future.

Management considers 1981's consolidated revenue growth of 6.4 percent to be satisfactory, when viewed in the perspective of a troubled national economy. Because major occupancy shifts exert significant leverage on revenues, particularly on Hilton's wholly-owned hotels, a strengthened business climate should prompt healthy revenue increases.

### Operating Costs

Operating costs for rooms, food and beverage, and casino departments have generally risen proportionately with revenue increases over the past three years. Despite declining occupancy, management has maintained profit margins at acceptable levels with stringent control of variable costs. Further operating efficiencies are planned in 1982.

Energy costs increased 18.7 percent in 1981 in Hilton's 50% or more owned hotels and by 69.4 percent over three years, even though energy consumption in this same period has declined. The efficiencies brought about by our investments in new energy systems should contain this escalating cost in the future.

Marketing expenses for these same properties increased by 18.4 percent in 1981, consistent with our intensified media advertising campaign and market programs described elsewhere in this report. Marketing expenses for all of Hilton's owned and managed hotels have increased 53.2 percent over the past three years.

### Income Contribution

Total operating income declined by one percent in 1981, after advancing 11 percent the prior year. Lower occupancy and the aforementioned pressure on departmental margins has held operating income essentially static in this period.

The proportionate contribution from Hilton's three primary sources of operating income has remained nearly the same in the past three years.

Operating Income Contribution
(In Millions of Dollars and Percent)

| | 1981 | 1980 | 1979 |
|---|---|---|---|
| Hotels | $ 71.7- 37% | $ 71.6- 37% | $ 65.0- 37% |
| Hotel-Casinos | 79.1- 41 | 80.0- 41 | 69.9- 40 |
| 22%-50% Owned Companies | 42.1- 22 | 42.9- 22 | 40.3- 23 |
| | $192.9-100% | $194.5-100% | $175.2-100% |

Income from short-term investments has become a significant part of the Company's total profit spectrum. Consolidated interest and dividend income, net of interest expense, rose to $16.5 million in 1981, a 30 percent increase over the prior year and a ten-fold increase over 1979, which was the first year in Hilton's history that interest and dividend income exceeded interest expense. The Company's inherently strong financial position allowed us to benefit from abnormally high interest rates throughout 1981. During the year, Hilton had on average approximately $163 million invested in short-term securities.

### Financial Condition

The Company enjoys one of the strongest financial positions in the lodging industry, which is a highly capital intensive industry. The previously described increase in investment income is one of many results of our financial strength.

During the last three years, $237.1 million has been spent on property additions to wholly-owned and leased hotels and the Company has invested another $20 million in 22%-50% owned properties. In the same period, long-term debt was reduced by $54.6 million, working capital increased by $48.7 million to $109.1 million, and cash and temporary investments increased by $43.2 million to $145.6 million.

In 1981, our unusually large capital expenditures for property and equipment additions—$124.6 million—resulted in a $23 million decline in working capital during the year. Nonetheless, at year-end our working capital nearly equalled the total of our long-term debt.

Strong cash flow coupled with a low debt amortization schedule—only 9 percent of cash flow in the past three years—has enabled the company to finance expansion internally.

During the last three years the funds provided from operations have increased by $53.6 million and totalled $141.4 million in 1981. Over the last five years this flow has increased at a compound annual rate of 24.3 percent.

A few key measurements of Hilton's financial strength and the resulting benefits to stockholders are presented below.

| Financial Measurements<br>Compound Annual Growth 1976-1981 | |
|---|---|
| Working capital at year-end | 31.4% |
| Funds provided from operations | 24.3% |
| Total assets | 14.8% |
| Net book value of hotel properties* | 9.1% |
| Fair market value of hotel properties* | 22.2% |
| Stockholders' equity per share | 17.8% |
| Dividends per share | 34.3% |

*Includes Hilton's proportionate share of 22%-50% owned properties.

The Company's capitalization continues to strengthen. Long-term debt at the close of 1981 totalled $119.5 million, representing only 18.3 percent of total capital and 22.4 percent of stockholders' equity.

Stockholders' equity has advanced from $386.3 million at year-end 1979 to $532.6 million in 1981. It has grown at a compound rate of 18.2 percent annually in the past five years.

Management expects near-term cash requirements to be met from temporary investments and cash-flow from operations. As a result of the Company's excellent credit rating, short-term borrowing needs could be met through utilization of revolving credit agreements or through issuance of commercial paper.

Included in the Company's balance sheet at December 31, 1981 was an investment in Avco Corporation common stock which had a market value of $13.3 million and represents an additional source of cash.

From the longer term perspective, management anticipates the continuing need to make major investments in facilities. In the event that a number of major projects come to fruition and offer significant profit opportunities, it may be prudent and necessary for the Company to acquire long-term financing. The Company has a strong financial condition, a very small amount of debt and a large unused borrowing capacity. If the need arose, the Company could obtain capital from such sources as long-term debt financing or equity financing.

During 1981, the Company entered into a safe-harbor tax lease under the Economic Recovery Tax Act of 1981, which will provide funds aggregating in excess of $52 million by 1985 through deferral of income tax liabilities otherwise payable. That sum will be repayable on a ratable basis in the normal course of tax installments during the period 1986 through 1993.

Aside from Hilton's extraordinary liquidity, one of our principal financial strengths is our highly valuable hotel real estate. As discussed elsewhere in this report, the current value of our assets far exceeds the amount stated on the company's historical cost balance sheet. The total current value of our assets advanced to $2.4 billion at the close of 1981, versus the book value of $816.5 million carried on our balance sheet. The current value of our assets has grown by $934 million in the past three years.

The Company has been able in the past, and believes it can continue, to adjust room rates and menu prices to substantially offset the effects of inflation. Inflation's impact on the current value of Hilton's assets is discussed under "Effects of Inflation—Supplementary Information", pages 38 through 43.

## MINING

### THE HANNA MINING COMPANY

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

In 1981 net income increased 14% from 1980, but is 19% less than 1979 when earnings were at an all-time high. Included in the 1981 net income are approximately $10.4 million of non-recurring gains, mainly from the sales of a copper property in Arizona and an ocean vessel.

In 1981 the funds flow of $28.2 million from operations, $12.9 million from investments in affiliated companies and $10.8 million from other sources, coupled with a $17 million net increase in debt, covered $46.4 million of capital investment in new plant and equipment and investments in associated and other companies, as well as $17.8 million for dividends.

Results of Operations

Net sales and operating revenues decreased 13% in 1981 from 1980. The decrease resulted from reduced sales of iron ore and nickel and loss of revenues from ocean chartering activities which were terminated in 1981.

Net sales and operating revenues decreased 18% in 1980 from 1979. Almost all of the decrease was the result of lower levels of iron ore operations in the U.S. and Canada.

Cost of goods sold and operating expenses decreased 4% in 1981 from 1980 following a 19% decrease in 1980 from 1979. The decreases are the result of lower volume of production and sales, but are not as great as the decreases in sales and operating revenues because of substantial increases in labor, materials and energy costs in both 1981 and 1980.

Competitive conditions in the iron ore pellet market have not permitted the company to pass through all of its increased costs to buyers in the form of increased selling prices. This is especially evident with sales in Europe where increasing losses have occurred because of depressed prices. In addition, the cost advantages inherent in operations which produce at capacity or near capacity are reduced when those operations must produce at lower levels. As a result, the gross margin for pellets has leveled off after a substantial decline from 1979. In 1981 the gross margin for nickel fell below 1979 and 1980 levels. This was the result of low prices.

Depreciation decreased 42% in 1981 with the indefinite shutdown of the Groveland iron ore pellet plant in Michigan.

Interest expense increased 53% in 1981 from 1980 as it became necessary to borrow more money for longer periods of time and at higher rates.

Income taxes in 1981 and 1980 were proportionately lower than in 1979 primarily because of the effect of the dividend received deduction.

Liquidity and Sources of Capital

The ratio of current assets to current liabilities was 1.7 at the end of 1981 compared to 1.6 at the end of 1980 and 1.7 at end of 1979. Working capital increased in 1981 along with the net increase in debt of $17 million. This followed a decrease in each of the last two years when acquisitions of WellTech, Inc. in 1979 and two new coal companies in 1980 were financed from working capital. Although inventories decreased in 1979, they have increased in both 1980 and 1981. In order to control product inventories and in line with reduced sales levels, the Groveland iron ore pellet plant was shut down for an indefinite period in January, 1981.

Financial resources and funds from operations were insufficient to meet requirements for funds in 1981, and are not expected to be sufficient in 1982. The Company had $100,000,000 in available credit at the end of 1981 under a bank revolving credit arrangement, of which $6 million was borrowed at December 31. During 1981 the Company made borrowings under this and other arrangements which varied in amounts up to $43.5 million, as compared to 1980 when the maximum amount borrowed was $39 million. At December 31, 1981, $10 million of 16% promissory notes along with the $6 million of revolving credit had been added to long-term debt. It is expected that a large part of the revolving credit will be utilized in 1982 for projected capital expenditures, including the January, 1982 acquisition of approximately 50% of Midland SouthWest Corporation for $46.5 million. These expenditures may be funded in part through issuance of medium to long-term fixed rate debt when advantageous to the Company.

As a result of the increase in debt in 1981, the percentage of long-term debt to total capital increased to 13.9%, compared to 11.5% at the end of 1980 and 11.7% at the end of 1979.

There have been no other significant changes in capitalization during the past three years, nor has the Company entered into any significant financing arrangements not reflected in the financial statements.

## MEDICAL AND OTHER HEALTH SERVICES

### BEVERLY ENTERPRISES

*Management's Discussion and Analysis*

Beverly's business consists principally of operating skilled and intermediate care nursing facilities.

Liquidity and Capital Resources

The long-term health care industry is capital intensive. Because of depreciation and the amortization of facility leasehold rights, Beverly generates significant cash flow over and above its net income. In addition, an unsecured line of credit totaling $10,000,000 is available, none of which was used at December 31, 1981. Beverly is negotiating an increase in its unsecured bank line of credit from $10,000,000 to $15,000,000 as well as a three-year, $30,000,000 revolving loan agreement with a bank. This line of credit may include certain requirements to maintain a minimum tangible net worth, debt coverage ratio and current ratio. Beverly anticipates that expenditures for normal recurring capital additions and debt service will be financed from operations. Major acquisitions are financed generally with a combination of cash down payments, assumption of mortgage debt and long-term leases, and issuances of notes payable and industrial revenue bonds and notes.

During 1981, Beverly was able to generate additional working capital as well as funds for acquisitions through an issuance of common stock with net proceeds of $37,656,000. Acquisitions during 1981 were partially financed through increases in long-term obligations of $87,854,000 and issuance of common stock valued at $29,986,000. In February 1982, 1,250,000 shares of common stock were issued to HCA for $30,000,000 in cash. These funds will be used for working capital requirements and acquisitions and are subject to ratification at the annual meeting of shareholders.

Operating Results

Revenues in the accompanying consolidated statements of income reflected an increase of $110,000,000 and $102,000,000 in 1981 and 1980, respectively, as a result of acquisitions. The balance of increased revenues during these periods resulted principally from increases in Medicaid, Medicare and private patient rates.

Increased operating costs as a result of acquisitions totaled $96,000,000 and $94,000,000 in 1981 and 1980, respectively. Increased costs resulting from increases in minimum wages totaled $16,000,000 and $4,500,000 in 1981 and 1980, respectively. The principal increases in depreciation and interest were the result of acquisitions. The balance of the increased costs resulted from supplies, utilities and merit increases in wages. See pages 14 and 15 for a discussion of the effects of inflation.

## MOTION PICTURE PRODUCTION

### FILMWAYS, INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Results of Operations

During fiscal 1982, the Company consummated the sale of two of its subsidiaries and announced its intention to sell two other subsidiaries. (These discontinued operations are more fully described in Note 8 of Notes to Consolidated Financial Statements.) In order to provide comparability, operating results for fiscal years prior to 1982 have been restated to reflect the effect of such discontinued operations.

During fiscal 1982, revenues decreased by 8% from fiscal 1981, while fiscal 1981 revenues decreased 8% from the $111,781,000 recorded in fiscal 1980.

The decrease in revenues in fiscal 1982 was due primarily to the poor performance of theatrical films released. The decrease is also due in part to the sale or discontinuance of animated and gameshow television and audio services activities. A partial offset was provided by syndication revenues from "Saturday Night," an increased level of activity in filmed television and an increase in revenues from higher sales volume of electronic equipment.

The decrease in revenues in fiscal 1981 was due primarily to lower theatrical film rentals resulting from the absence of a box office success such as "Amityville Horror" released in the prior fiscal year accompanied by the poor performance of pictures released during such fiscal year. Also, a decline in television productions and disruptions to the delivery schedule of completed product caused by industry strikes contributed to this decrease. Increased electronic equipment sales provided a partial offset to such decreases.

Cost of sales for fiscal 1982 decreased 9% from fiscal 1981, while fiscal 1981 was 34% greater than the cost of sales for fiscal 1980. The decrease in fiscal 1982 was related to a lower level of amortization on film product and the sale or discontinuance of animated and gameshow television and audio services activities. The decrease was partially offset by the costs associated with the syndication of "Saturday Night," and the costs related to the increased activity in filmed television. The increase in cost of sales in fiscal 1981 was primarily attributable to costs associated with an increased number of theatrical films released during that fiscal year and substantial writeoffs of theatrical film inventory and development costs, which were partially offset by a reduction in cost connected with lower television revenues.

Selling, general and administrative expenses decreased 1% in fiscal 1982 over fiscal 1981, and increased 56% during fiscal 1981 as compared to fiscal 1980. The decrease during fiscal year 1982 resulted from lower entertainment and corporate expenses reflecting staff reductions and the closing of certain branch offices in the theatrical film subsidiary along with the sale or discontinuance of animated and gameshow television and audio services activities. Increased expenses related to the syndication of "Saturday Night," increased corporate expenses related to higher rent and nonrecurring costs associated with the staff reductions and the purchase agreement and increased expenses in the electronic equipment manufacturing subsidiary provided offsets to the decreases noted above. The increase in fiscal 1981 as compared to fiscal 1980 resulted from higher entertainment expenses associated with the full year impact of a subsidiary acquired in July, 1979 together with an expansion of television development activity. Corporate expenses increased primarily due to higher professional fees and the establishment of a reserve for doubtful accounts.

Interest expense (net of $2,166,000 and $3,699,000 of interest capitalized during fiscal 1982 and fiscal 1981, respectively) decreased 19% in fiscal 1982 compared to the prior year and increased 106% in fiscal 1981 as compared to fiscal 1980. The decrease in interest expense during fiscal 1982 primarily reflected the reduction of outstanding loan balances following the sale of two of the Company's subsidiaries in June, 1981. The increase in interest expense in fiscal 1981 was due primarily to the inclusion of borrowings related to increased production activity; full year effect of borrowings associated with the Company's acquisition of a subsidiary in July, 1979; higher levels of borrowing for general corporate purposes; and significantly higher prime rates.

### Liquidity and Capital Resources

As a result of the capital infusion transaction that occurred on February 8, 1982, the Company ended fiscal 1982 with cash on hand of approximately $28,500,000, an amount in excess of its bank debt then outstanding. Subsequent to year end, the Company entered into a new loan agreement with four banks which provides for borrowing of up to $55,000,000. The amount available under this line at any time varies depending upon the amount of the Company's inventory, receivables and liabilities.

The Company has also entered into a production financing arrangement with Home Box Office, Inc. (HBO), a subsidiary of Time Incorporated, pursuant to which it is receiving substantial additional capital that will be invested in new film product. The Company further expects to generate substantial cash from foreign pre-sales of its motion pictures as well as from equity investors in the motion pictures. Sales of discontinued companies may also provide additional cash in the nearterm. The Company expects to generate sufficient cash flow from the distribution of its existing film library and of "Saturday Night" to cover its ongoing overhead and interest expenses. It therefore anticipates that any new borrowings made under its new revolving credit arrangement, together with advances from HBO, and monies received from foreign presales and third party investors will all be available to finance new motion picture and television production.

### Quasi-Reorganization

As set forth more fully in Footnote 3 to the Company's consolidated financial statements, the Company, in accordance with generally accepted accounting principles, effected a quasi-reorganization at February 28, 1982. In connection with the quasi-reorganization, management evaluated all of the assets and liabilities of the Company. Management particularly focused its attention on two of the Company's most significant assets—the film library and the distribution system. The film library consists of over 600 theatrical and television motion pictures and other product produced for television. The film distribution system is a seasoned organization that has been in existence for over twenty-five years. In connection with the quasi-reorganization, the Company engaged outside investment bankers to review and determine the current value of both the film library and the distribution system. As part of the evaluation of the library, management and its advisors recognized that there is increased demand for product due to the cable TV, video cassette and video disc markets. The new valuation was made after giving effect to the various write-downs of current film releases that were made in fiscal 1982.

As a result of the quasi-reorganization, the Company restated its film library to estimated fair value which increased film inventories by $18,217,000 to approximately $57,000,000; eliminated existing goodwill and assigned a portion of such value to its film distribution system at its estimated fair value of $14,000,000; restated its subordinated debentures and contracts payable due after one year to current market value which resulted in a debt discount of $21,303,000; and transferred its accumulated deficit of $77,894,000 to paid-in surplus.

## RAILROAD TRANSPORTATION

### CHICAGO AND NORTH WESTERN TRANSPORTATION COMPANY

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Liquidity and Capital Resources—

During 1981, working capital (excluding long-term debt payments due within one year) increased $3.7 million to a year-end balance of $22.6 million.

The Company has arranged commitments for $345 million and up to $69 million for over-runs, if required, to finance construction for its Wyoming coal project.

The Company has consistently met debt obligations when due and has maintained a good relationship with the financial community. Consequently, the Company experiences few problems in obtaining financing for rolling stock and work equipment additions. Early in 1982, new lines of credit totaling $25 million were established.

Results of Operations—

Operating revenues increased $46.1 million, or 5%, in 1981 over 1980 principally due to diesel fuel oil surcharges and general freight rate increases. Carloadings decreased 6% as a result of depressed economic conditions, with declines in virtually every category of traffic.

1981 operating expenses increased approximately 6% over 1980. Labor costs increased $24.2 million principally because of scheduled increases in rates of pay. Payroll taxes and fringe benefits increased $17.3 million as a result of increased payroll tax rates on the increased labor and increased costs of fringe benefits. Diesel fuel oil costs increased $8.7 million as a result of an 18% increase in the average cost per gallon used, partially offset by a 9% decrease in gallons used. The cost of other material used increased $5.1 million. Freight car and locomotive rentals decreased $8.8 million as a result of the decrease in business. Casualty costs decreased $10.9 million and depreciation expense and property taxes increased $2.8 million and $1.5 million, respectively.

In 1980, revenues increased $188 million over 1979. Diesel fuel oil surcharges and general freight rate increases contributed significantly to the $175 million increase in freight revenue. Also, contributing strongly was an all time record movement of grain, a 22% increase in coal carloadings and a 10% increase in movements of beverages and food other than grain. The demise of the Rock Island and the cutback in Milwaukee Road service created more demand for the service of the Company in the grain-growing region of the Midwest.

Inflation increased costs dramatically in 1980. Diesel fuel oil costs increased $44.8 million in 1980 over 1979 due to increases in both price and gallons used, the average cost per gallon increasing 48% from 58 cents in 1979 to 86 cents in 1980. Labor costs increased $42.6 million, both because of scheduled increases in rates of pay and an increase of about 3% in hours worked. Material unit costs, combined with increased use of materials, produced an increase of $13.9 million, Payroll taxes and fringe benefit costs increased $15.9 million. Car hire costs increased $9.2 million as a result of increased carloadings, increased rental rates and an increase in the number of system cars acquired under operating leases.

Deferred Maintenance and Delayed Capital Expenditures

The Company's maintenance and capital expenditures enable it to provide competitive service. Substantial additional expenditure would be required to achieve standards which would preclude deferred maintenance and delayed capital expenditures, such as track structure capable of accepting cars of 100-ton capacity, speed limits of 60 M.P.H. on signaled main lines, 49 M.P.H. on other main lines and 30 M.P.H. on retained branch lines, and a bad order ratio not exceeding 5% for freight cars. By these standards, at December 31, 1981 and 1980, respectively, deferred maintenance (direct costs categorized in accordance with ICC accounting regulations and stated at price levels applicable at the reported dates) was $717,680,000 and $788,898,000, respectively, and delayed capital expenditures (similarly categorized and stated) were $489,518,000 and $524,272,000, respectively. While such additional expenditures would improve efficiency of operations, the Company does not regard them as necessary to its ability to provide competitive service.

## CAMPANELLI INDUSTRIES INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

### Liquidity and Capital Resources

During fiscal 1982, the Company consolidated certain short-term borrowings by entering into a $13 million revolving credit construction loan agreement with certain lenders of which approximately $11 million was outstanding at January 31, 1982. During fiscal 1980, the Company issued $15 million of 12-7/8% Senior Subordinated Sinking Fund Debentures. The net proceeds to the Company from the sale of the debenture issue, approximately $14 million, was used to retire certain short-term debt, as well as to provide funds needed to expand the Florida housing operations.

Internal financing of construction is done on a selective basis, generally for those projects where significant sales prior to the commencement of construction assure a rapid turnover.

The Company's liquidity is affected by many factors including the number of residential units sold and the level of construction. During fiscal 1982, the Company experienced a 32% decline in the number of closings of residential units. In addition, net income and profit margins were adversely affected by increased costs of financing which the Company was unable to pass on to its customers. The Company received funds from the sales of recreation leases and property and equipment. In response to the depressed state of the housing industry brought on by sustained high interest rates, the Company has substantially reduced its construction activity in all markets other than selected markets in Florida. In addition, the Company is reducing overhead, where possible, and is disposing of certain tracts of land in areas where it has terminated activity.

### Results of Operations

#### Fiscal 1982 Compared with Fiscal 1981

Revenues from the sales of residential units declined by approximately $14,700,000 or 29% from fiscal 1981 levels. The change resulted primarily from a decline in the number of units closed from 800 in fiscal 1981 to 544 in fiscal 1982. This decline was partially offset by a 4% increase in the average unit selling price. Gross profit on residential units sold increased by 5% over fiscal 1981 as a result of a change in the types and location of units sold.

As more fully described in Notes 3, 7 and 10 to the consolidated financial statements, the Company recognized losses before income tax benefits in the amount of $4,779,000 with respect to the net realizable value of inventory, settlements of litigation and land purchase options. In addition, gains before income taxes of $1,449,000 resulted from the sales of recreation leases and certain property and equipment.

#### Fiscal 1981 Compared with Fiscal 1980

Revenues in 1981 from the sale of residential units decreased by approximately $5,500,000, or 10% from 1980 levels. This change is due maintaly to a 7% decrease in the average unit selling price, resulting partially from the Company's decision to curtail operations in the Illinois market, where the average selling price approximates $113,000, and direct most of the Company's resources and marketing effort to the Florida Division where the average selling price is approximately $59,000. In addition, revenues decreased due to a decline in units delivered from 828 in 1980 to 800 in 1981.

The Company was able to maintain relatively stable gross profit margins by increasing selling prices to offset continuing construction cost increases and high interest rates.

Interest cost incurred in 1981 increased by $1,283,000 or 29% over 1980, while the amount of interest capitalized remained constant for the two years. This increase in interest charged to operations was due mainly to the effects of Statement of Financial Accounting Standards No. 34, "Capitalization of Interest Cost," which requires interest to be expensed on all projects not under active development as well as on those which are substantially complete.

Income taxes increased as a percentage of Income before taxes and an extraordinary item, primarily as a result of the lower federal tax rate applicable to the capital loss on the sale of land in Virginia (described in Note 16 to Consolidated Financial Statements).

## ASSOCIATED DRY GOODS CORPORATION
*Management's Discussion and Analysis*

### Results of Operations

*Sales.* As a result of continued internal growth and the addition of new stores, department store sales increased 10.6% compared with an improvement of 9.5% a year ago. Including the sales of Caldor from the date of acquisition (May 27, 1981), total Company sales in 1981 increased 40.9%.

*Miscellaneous Expense/Revenue.* Miscellaneous expense in 1981 was $1.1 million compared with miscellaneous revenue of $4.8 million a year ago. The negative variance was primarily attributable to the recording in 1981 of a $9.1 million charge relating to discontinued properties, offset by a $2.2 million insurance settlement resulting from a fire.

*Cost of Sales and Selling, General and Administrative Expenses.* The cost of sales (including occupancy and buying costs) as a percent to sales for the last three years were 75.0%, 74.9% and 74.9% for 1981, 1980 and 1979, respectively. Selling, general and administrative expenses as a percent to sales were 18.1%, 19.0% and 19.5% for 1981, 1980 and 1979, respectively.

As is typical for a discount department store operation that offers its customers nationally advertised brands at low prices, Caldor relies on high volume and fast inventory turnover, resulting in lower expense ratios to compensate for their lower merchandise margins as compared with a more traditional department store. Accordingly, the 1981 ratios noted above were significantly impacted by the acquisition of Caldor.

Excluding the impact of Caldor, the cost of sales ratio showed a reduction of approximately .6% due to improved operating income results, and a reduction of the LIFO charge. The selling, general and administrative expense ratio related to department stores showed a modest improvement, primarily as the result of higher sales levels.

*Interest/Income Taxes.* See page 21 of this report for a discussion of interest and income taxes.

### Liquidity and Capital Resources

As indicated on the facing page, the Company has been able to maintain satisfactory working capital levels in each of the last three fiscal years. The ratio of working capital, however, has declined from the two previous years primarily as the result of the lower working capital required by Caldor's operation.

Long-term debt increased substantially in 1981 due to the issuance of long-term debt in connection with the Caldor acquisition ($174.2 million). As a result, the ratio of long-term debt to shareholders' equity increased to 53.2% in 1981 compared with 28.8% a year ago and the interest coverage ratio decreased to 3.0 compared with 5.0 in the prior year.

Capital additions and dividend distributions have been funded for the most part through operations in each of the last three years. In 1982, the Company expects to spend approximately $90.0 million for capital expenditures which reflects an increased number of department store renovations, as well as, the capital expenditure needs of the Caldor subsidiary. The Company intends to continue to finance capital expenditures with funds primarily generated from operations. However, the Company will continue to utilize long-term financing when favorable market conditions prevail.

For further details relating to the financial impact of the Caldor acquisition, see the "Acquisition of Caldor, Inc." and "Long-Term Debt" footnotes to the Consolidated Financial Statements on pages 15 and 27, respectively.

For a discussion of credit lines and short-term financing, see "Financing" on page 31 of this report.

*Changing Prices.* For an analysis of the impact of the effects on the business of changing prices and inflation, see pages 32 and 33.

*Recent Developments.* The Company filed a registration statement for a $100 million note offering with the Securities and Exchange Commission with the intention of using the proceeds to reduce long-term bank debt by $35 million and to repurchase a portion of accounts receivable sold to Associated Dry Goods Credit Corporation. Financial market conditions will determine if and when this transaction will be consummated.

## DONALDSON, LUFKIN & JENRETTE INC.

*Management's Discussion and Analysis of Financial Condition and the Results of Operations*

Five-Year Financial Data
(in thousands, except per share data)

| | 1981 | 1980 | 1979 | 1978 | 1977 |
|---|---|---|---|---|---|
| Commissions | $ 98,025 | $ 93,555 | $ 61,347 | $ 54,811 | $ 21,255 |
| Fees | $ 55,806 | $ 36,218 | $ 26,273 | $ 21,275 | $ 15,555 |
| Underwriting Income | $ 17,038 | $ 12,144 | $ 5,034 | $ 4,074 | $ 3,746 |
| Total Operating Revenues | $ 295,920 | $ 232,176 | $ 163,456 | $ 133,314 | $ 56,538 |
| Net Earnings | $ 13,255 | $ 8,750 | $ 3,750 | $ 2,500 | $ 275 |
| Net Earnings Per Share | $ 1.26 | $ 0.97 | $ 0.43 | $ 0.30 | $ 0.04 |
| Average Shares Outstanding | 10,465 | 9,045 | 8,735 | 8,290 | 7,416 |
| Dividends Per Share | $ 0.18 | $ 0.15 | $ 0.14 | $ 0.14 | $ 0.14 |
| Total Assets | $4,868,026 | $3,474,451 | $2,343,130 | $2,141,459 | $1,965,838 |
| Securities Purchased Under Resale Agreements | $2,889,540 | $1,328,451 | $1,359,019 | $ 821,452 | $1,085,692 |
| Securities Sold Under Repurchase Agreements | $3,309,973 | $2,523,464 | $1,342,360 | $1,320,219 | $1,123,836 |
| Long-term Debt | $ 59,714 | $ 35,532 | $ 19,075 | $ 25,830 | $ 22,850 |
| Stockholders' Equity | $ 107,043 | $ 67,965 | $ 59,739 | $ 57,663 | $ 53,891 |
| Stockholders' Equity Per Share | $ 8.52 | $ 7.67 | $ 6.85 | $ 6.59 | $ 6.53 |
| Regulatory Capital: | | | | | |
| Net Capital In Excess Of Minimum Regulatory Requirements: | | | | | |
| DLJ Securities Corp. | $ 32,200 | $ 34,200 | $ 23,000 | $ 15,000 | $ 19,000 |
| ACLI International Commodity Services, Inc. | $ 9,117 | * | * | * | * |
| Regulatory Net Capital Ratios: | | | | | |
| DLJ Securities Corp. | 10.3% | 11.0% | 11.4% | 10.7% | 12.0% |
| ACLI International Commodity Services, Inc. | 14.0% | * | * | * | * |

*not applicable—see note 2

Inflation and Trends:

The Company's business is affected by general trends in business and finance, the overall state of the economy and changes in the regulatory environment. The volume of business done by the Company and revenues generated therefrom are influenced by the volume of securities and commodities transactions in various markets in the U.S. and abroad, securities and commodities prices and the level and volatility of interest rates. Since the nature of the Company's business is to provide services, and large investments in plant and equipment are not required, and because securities and commodities are carried at market or fair value with all changes in value reflected in revenues, and the turnover of such assets is relatively high, the effects of inflation on reported historic earnings are not significant.

Capital and Liquidity:

The majority of the Company's assets are highly liquid and short-term in nature. Customer transactions are collateralized by marketable securities. A significant amount of leverage is inherent in these assets, as funds are usually available on an overnight basis from banks and other institutions versus the pledge of Company and customer owned assets. In addition to traditional borrowings from banks, on an overnight basis, a substantial amount of financing is done utilizing repurchase and resale agreements. These transactions primarily represent financing arrangements, secured by U.S. Government and/or other money market securities, on an overnight or term basis and with fixed or variable interest rates generally near the level of the Federal Funds rate. A substantial amount of the repurchase and resale agreements, reflected in assets and liabilities, results from a "matched" book business done by DLJ Securities Corp. and ACLI International Government Securities, Inc., subsidiaries which are Primary Dealers reporting to the Federal Reserve Bank. Capital needs are determined in proportion to the amount and mix of assets. Sources of capital, in addition to short-term overnight borrowings, are represented by term debt issued by the Company and its subsidiaries, deferred payments for compensation, taxes and the like and by stockholders' equity. Certain minimum amounts of capital must be maintained to satisfy regulatory requirements in the Company's principal broker-dealer subsidiary, DLJ Securities Corp., and its principal futures commission merchant, ACLI International Commodity Services, Inc. ("ACS"). The regulatory requirements represent Uniform Net Capital rules designed to measure the general financial integrity and liquidity of registered broker-dealers and futures commission merchants and provide minimum acceptable net capital levels to satisfy commitments to customers. Unless the defined minimum regulatory capital is maintained, regulated broker-dealer subsidiaries would be prohibited from paying dividends to the Company. At December 31, 1981, both DLJ Securities Corp. and ACS were in compliance with the Uniform Net Capital rules and had capital substantially in excess of the minimums required. Sources of capital funds at December 31, 1981, which total $173.4 million are long-term debt of $59.7 million, deferred compensation, taxes, etc., of $6.7 million and total stockholders' equity of $107.0 million. At the end of 1980, total capital funds amounted to $105.4 million. Management of the Company does not anticipate any difficulty replacing the debt maturing in the immediate future, should it elect to do so.

The Company does not maintain any short-term borrowing capacity beyond that inherent in its ability to finance customer and firm securities positions; in connection with the commodities merchanting business of ACLI, contingent liabilities exist of approximately $56.5 million for unused import and commercial letters of credit at December 31, 1981.

Results of Operations:

Record share volume traded on the nation's stock markets, unprecedented levels of interest rates on fixed income securities and short-term borrowings, extreme degrees of price volatility in the securities and commodities markets and an annual double digit inflation rate have been the principal characteristics of the three year period ended December 31, 1981.

*1981 Compared to 1980*—Net Earnings increased in 1981 to $13.22 million, or 51%, from $8.75 million in 1980. Net earnings per share increased to $1.26, or 30%, from $0.97 in 1980. The average number of common shares and common share equivalents outstanding during 1981 increased to 10.5 million, from 9.0 million during 1980; an increase of 17%. The 51% increase in net earnings was achieved on a 27% increase in total revenues. Changes in the individual components of revenue are as follows:

| | Year | | Change | |
|---|---|---|---|---|
| | 1981 | 1980 | Amount | Pct. |
| | (in millions) | | | |
| Commissions | $ 98.1 | $ 93.6 | $ 4.5 | 5% |
| Fees | 55.8 | 36.2 | 19.6 | 54% |
| Underwriting income | 17.0 | 12.1 | 4.9 | 40% |
| Interest income | 84.9 | 65.2 | 19.7 | 30% |
| Dealer and trading gains, net | 28.8 | 19.5 | 9.3 | 48% |
| Long-term corporate development investment gains, net | 6.3 | 1.9 | 4.4 | 232% |
| Other | 5.0 | 3.7 | 1.3 | 35% |
| | $295.9 | $232.2 | $63.7 | 27% |

Commission revenue increased $4.5 million in 1981 and includes $3.1 million generated by ACLI, which is included in the results of operations commencing December 1, 1981. Fees increased $19.6 million as a result of the growth of assets managed by DLJ's Money Management Division and an increase in volume and size of transactions completed by DLJ's Investment Banking Division. Underwriting income increased $4.9 million as a result of DLJ's participation in a greater number of capital raising transactions compared to 1980. Interest income increased $19.7 million; $16.8 million of the increase relates to increased levels of customer margin interest as both interest rates and the amount of customer margin debit balances were higher in 1981 compared to 1980. Effective in 1981, interest income in DLJ's financial statements is presented net of interest expense to finance money market instruments. This presentation has been adopted since it more clearly reflects the nature of the substantial "matched book" repurchase business of DLJ without distorting the overall significance of this activity relative to the whole of DLJ's activities. Prior presentations have been reclassified to conform to the current presentation. Accordingly, interest expense of $283.5 million in 1981 and $252.9 million in 1980 has been deducted from gross interest income. Dealer and trading gains, net increased $9.3 million and reflect the improved results of DLJ's Fixed Income Division, primarily the Government Bond Unit. Long-term corporate development investment gains net increased $4.4 million in 1981. This overall net gain represents a combination of realized gains from sales of investment positions and changes in the fair market value of unsold investment positions. In 1981, realized gains from sales amounted to $3.3 million and changes in unrealized appreciation of investment positions amounted to $3.0 million; this compares to realized gains of $1.6 million in 1980 and changes in unrealized appreciation of $0.3 million. Long-term corporate development investments are generally categorized as non-marketable securities. Valuations of these investments are established quarterly, with the approval of the Board of Directors of the Company, and changes in valuation are included in revenues. Other revenues, which include dividends and miscellaneous billings to customers, increased $1.3 million.

Total expenses aggregated $272.4 million in 1981, up $56.1 million or 26%, from 1980. Employee compensation and related benefits increased by $26.2 million and are related to the increases in revenues, an overall higher level of profitability and a larger staff in 1981. Base salaries and employee benefits increased by $15.4 million. Interest expense increased $13.1 million as both the cost of funds and the level of borrowings to finance customer and firm positions were higher in 1981, compared to 1980. Floor brokerage, exchange and clearing related costs increased $5.0 million. The increase in these costs results from increases in volume of transactions and generally higher costs associated with the clearance of securities and commodities transactions. Communications expenses increased to $12.6 million from $9.4 million in line with the greater volume of business done in 1981 versus 1980, the increase in geographic locations of the Company's offices, costs related to the installation of a modern communications network and cost increases associated with the basic services utilized by various businesses. Occupancy and equipment increased as various locations expanded their office facilities during the year, new office locations were started and leases renewed at higher rates. Other operating expense increases are in line with the above, for substantially the same reasons.

The effective rate of income taxes in 1981 amounted to 44% versus 45% in 1980.

*1980 Compared to 1979*—Total revenues were $232.2 million in 1980 compared to $163.4 million in 1979, an increase of 42%. Changes in the individual components of revenues are as follows:

| | Year | | Change | |
|---|---|---|---|---|
| | 1980 | 1979 | Amount | Pct. |
| | | (in millions) | | |
| Commissions | $ 93.6 | $ 61.3 | $ 32.3 | 53% |
| Fees | 36.2 | 26.3 | 9.9 | 38% |
| Underwriting income | 12.1 | 5.0 | 7.1 | 142% |
| Interest income | 65.2 | 56.8 | 8.4 | 15% |
| Dealer and trading gains, net | 19.5 | 8.3 | 11.2 | 135% |
| Long-term corporate development investment gains, net | 1.9 | 2.3 | (0.4) | (17%) |
| Other | 3.7 | 3.4 | 0.3 | 9% |
| | $232.2 | $163.4 | $ 68.8 | 42% |

Commission revenue increased $32.3 million in 1980 and resulted from increased volume, market share and size of average transactions processed. Fees increased $9.9 million, of which $6.0 million resulted from the growth of assets managed by DLJ's Money Management Division and the balance from an increase in volume and size of transactions completed by DLJ's Investment Banking Division. Underwriting income increased as a result of DLJ's participation in a greater number of capital raising transactions versus 1979. Interest income increased due to the rise in interest rates in 1980 over 1979 and because of the rise in customer margin debit balances. Dealer and trading gains, net increased $11.2 million over 1979 primarily as a result of trading gains in DLJ's Fixed Income Division versus losses incurred in 1979. Long-term corporate development investment gains net were $1.9 million in 1980 compared to $2.3 million in 1979. Of the $2.3 million reported in 1979, realized gains from sales amounted to $5.6 million and a reduction in unrealized appreciation of investment positions amounted to $3.3 million.

Total expenses aggregated $216.3 million in 1980 compared to $157.3 million in 1979, an increase of 38%. Employee compensation and related benefits increased by $35.5 million and are related to the increases in revenues, an overall higher level of profitability and increased staff. Base salaries and employee benefits increased by $8.7 million. Interest expense increased $2.9 million due to the increased cost of funds and the level of borrowings to finance customer and firm positions. Floor brokerage, exchange, and clearing related costs increased $8.4 million and parallel the increase in commission revenues. All other costs increased $12.2 million or 35%; communications increased $1.4 million primarily as a result of volume increases; occupancy and equipment costs increased $2.6 million primarily as a result of expansion of the size of the Company's Systems and Operations groups and as a result of upgrading of computer hardware to handle the increased volume of transactions processed; other cost categories increased as a result of the increased volume processed, a major upgrading and conversion to a new data processing system, increases in customer and operations reserves and/or because of the effects of inflation on costs generally.

The effective rate of income taxes in 1980 amounted to 45%, compared to 39% in 1979. The increase is attributable to a greater amount of 1980 earnings taxed at higher rates relative to lower rates applied to such categories as long-term capital gains and dividend income.

Average common shares and common share equivalents outstanding in 1980 were 9.0 million shares compared to 8.7 million shares in 1979.

## TELECOMMUNICATIONS

### CONTINENTAL TELEPHONE CORPORATION

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

The Company's revenues, net income, earnings per share and dividends to common shareholders continued to grow. Revenues were up 23 percent in 1981 as compared to 1980, net income increased 17 percent, earnings per share grew 12 percent and dividends were increased to an annual rate of $1.56 per share, an increase of 8 percent over the comparable 1980 rate. These gains were mainly the result of the Company's continuing commitment to telephone operations and basic telephone service.

To take advantage of the opportunities provided by the move toward deregulation and increased competition in the telecommunications industry, increasing information demands, and new technology, the Company has recently made investments and related commitments in the developing markets of business communications systems and supply, information services, international consulting and contracting and network services. The results for the past three years reflect the developing nature of these businesses and we anticipate the efforts and investments being made today will provide the foundation for increasing benefits in the future.

#### Telephone Operations

Local service rate increases during 1981 amounted to $44 million on an annualized basis. Operations for 1981 reflect approximately $31 million of additional revenues as a result of the 1981 and 1980 rate increases. Local service revenues for 1980 and 1979 include approximately $11 million and $6 million, respectively, from rate increases and other local service rate adjustments. The number of main telephone access lines in service at year-end increased by 59,880 in 1981, 9,139 in 1980 and 66,733 in 1979. Internal main telephone growth was 2.9 percent, 3.5 percent and 4.3 percent for 1981, 1980 and 1979, respectively, reflecting the economic recession.

Toll service revenues have increased primarily as a result of increased costs incurred in providing toll services, increased toll plant investment and improved settlement ratios. Interstate long distance rates were increased approximately 16 percent in mid-1981 and approximately 5 percent in mid-1980 and this had a positive effect on the settlement ratios. Message volumes increased by 7 percent in 1981, 8 percent in 1980 and 11 percent in 1979.

Operating expenses have increased primarily due to higher wages, growth of plant and telephones in service, increases in work force, increases in other costs and the general effects of inflation. The Federal Communications Commission (FCC) amended its accounting requirements in the fourth quarter of 1981 to require expensing of costs incurred in installing telephone service on customers' premises. These costs have historically been capitalized, but are now being expensed when incurred and the local service revenue necessary to cover these increased expenses has, and is being addressed in rate case proceedings.

Depreciation and amortization increased substantially in 1981 over prior years due to the Company utilizing new procedures and higher rates for depreciating facilities and equipment which were approved by the FCC. This increase will permit the Company to recover its capital investment in a shorter period of time and therefore be in a more equitable position to compete in the changing telecommunications industry.

Federal income tax expense has increased primarily as a result of increased income. Telephone operations effective federal income tax rates for 1981, 1980 and 1979 were 39 percent, 40 percent and 40 percent, respectively.

The rate of increase in interest expense declined substantially in 1981 due to improved internal generation of construction funds and improved cash management programs. Interest expense for the prior years reflect additional borrowings for new plant facilities and higher interest rates on interim and long-term borrowings.

Business Communications Systems and Supply

The decline in the results for Business Communications Systems and Supply is primarily due to rapid expansion, declining margins as a result of product development delays, and increased marketing and development expenditures. The entrance into the developing business communications systems market has required certain initial and development expenditures for expansion and new products that have affected the profitability of these operations.

Consistent with this expansion and development, revenues have grown 79 percent over the past three years, including 31 percent for 1981. Also, consistent with this expansion, costs and expenses increased 36 percent in 1981 due primarily to increased product development, marketing and carrying costs. These product development and marketing efforts are expected to produce improved results in 1982.

Information Services

Revenues and income increased 43 percent and 32 percent, respectively, in 1981 as compared to 45 percent and 113 percent, respectively, in 1980 as demand for information services remained high. Margins in 1981 were somewhat adversely affected by acquisition costs and increased development expenditures.

International Consulting and Contracting

Income and revenues increased substantially in 1981 and reflect the acquisition of certain units of Page Communications Engineers on a purchase basis effective September 1981, and also reflect $3.8 million, net of tax, of income from foreign contract revenues deferred in prior years. Prior years' results reflect extensive marketing and sales efforts in the Middle East and Latin America.

Network Services

The Company's partnership interest in American Satellite Company (ASC) was established in July 1980. The results reflect the Company's interest in ASC's operations for 1981 and for the last five months of 1980. (See Note 10 of Notes to Financial Statements.)

Corporate—Interest, Expenses and Taxes, Net

The increase in net corporate expenses is due primarily to a 41 percent and a 23 percent increase in interest expense in 1981 and 1980, respectively, as a result of increased borrowings for subsidiary financing and acquisitions of new businesses. Net gains from the disposition of subsidiaries and other investments were recorded in prior years. (See Note 11 of Notes to Financial Statements.)

Financial Condition

At December 31, 1981, consolidated common equity as a percent of total capitalization, including short-term debt, was 36.6 percent as compared to 34.2 percent and 33.5 percent in 1980 and 1979. Short-term debt, excluding current maturities, as a percent of total capitalization, was 3.2 percent at December 31, 1981, as compared to 1.3 percent at December 31, 1980. (See Notes 3, 4 and 5 of Notes to Financial Statements.)

The consolidated ratio of earnings before income taxes and fixed charges to fixed charges, was 2.7, 2.7, and 2.9 at December 31, 1981, 1980 and 1979, respectively.

The Company's ability to generate cash to meet its needs is influenced primarily by future income, current debt and corporate objectives. In the last three years, the Company has invested $1.269 billion for property, plant and equipment, retired $277 million of long-term debt and preferred stock, invested $61 million for the purchase of new businesses and paid two-thirds of its income from operations in cash dividends. More than sixty percent of these requirements were financed by working capital provided from operations and the remainder was funded by the sale of common stock and the issuance of interim, intermediate and long-term debt.

Property, plant and equipment modernization and expansion programs normally take less than a year to complete and are expected to cost approximately $460 million for 1982, up 9 percent from the $421 million in 1981. The Company expects that future capital expenditures, which could be curtailed if economic conditions warrant, will continue to be financed for the most part by internal generation of funds and the remainder of its funding requirements, primarily repayment of debt, by new debt and equity funds.

The Company expects 1982 and the future to produce increased internal generation of funds as a result of the Economic Recovery Tax Act of 1981 which contains shorter tax depreciable lives and a requirement for public service commissions to normalize tax timing differences for rate-making purposes. In addition, regulatory authorities have recently recognized the need for substantially improved capital recovery procedures and increased depreciation rates which will contribute to improved internal generation of funds.

## WHOLESALE TRADE

### HUGHES SUPPLY INC.

*Management's Discussion and Analysis of Financial Condition and Results of Operations*

Your Company reached the $200 million plateau in total revenues for the current year, with total revenues of $203.9 million, an increase of 14.5%, as compared to revenues of $178.0 million last year. Fiscal 1981 revenues reflected an increase of 16.2% as compared to Fiscal 1980 revenues of $153.1 million. Marbut Company revenues of $16.8 million are included in the current year's revenues and accounted for 9.4% of the total increase of 14.5%. Net income for the current year was $5.2 million ($2.34 per share) as compared to $6.4 million last year ($3.12 per share) and $5.9 million ($2.92 per share) for the year ended January 25, 1980. The severe slump in the construction industry, along with first year losses related to the Marbut Company acquisition as of May 29, 1982, had a significant adverse impact on the current year's net income.

This analysis will refer to the Selected Financial Data, Sales by Product Group, Financial Information by Segments, Consolidated Statements of Income and Consolidated Statements of Changes in Financial Position as shown on Pages 2, 7, 8, 16 and 18 of this report.

Revenues:

Sales increases by product group and total company, excluding heating and air conditioning sales, which is a new product group for Hughes, are reflected in the following table:

| | Percentage Increase in Sales | | |
|---|---|---|---|
| | Fiscal 1982 | Fiscal 1981 | Fiscal 1980 |
| Electrical Supplies | 4.5% | 22.0% | 15.3% |
| Plumbing Supplies | 13.1%* | 11.8% | 24.0% |
| Electrical Utility Supplies | 23.8% | 6.9% | 10.7% |
| Building Materials and Contractors' Tools | 17.9% | 16.6% | 16.4% |
| Mobile Home Supplies | 14.4% | 38.5% | 39.2% |
| Total Gross Sales | 14.5%** | 15.9% | 18.5% |

*Includes Marbut Company, which accounted for 12.5% of the total increase in this product category.

**Includes Marbut Company total gross sales $16.9 million, representing 8.3% of the total increase.

Electrical and electrical utility supplies accounted for approximately 49% of total sales, plumbing and industrial supplies accounted for approximately 40% of total sales, and all other categories accounted for 11% of total sales. Heating and air conditioning supplies, related to the Marbut Company acquisition, accounted for 3% of total Company sales.

The severe decline in housing starts over the past two years has adversely affected the growth of plumbing related sales, while increased commercial construction activity, principally in the Greater Orlando and the Tampa-St. Petersburg areas, has generated increased sales in electrical related items. Sales of Marbut Company, a distributor of plumbing, heating and air conditioning supplies, have been adversely affected by the general decline in residential construction in Georgia and South Carolina, which has been more severe than in Florida.

The sales of manufacturing divisions reflected a 4.6% increase for the current year as compared to a 7.0% sales decrease in fiscal 1981 compared to fiscal 1980. Increased utility construction, which also directly affects the prestressed concrete division, accounted for the increased utility sales in fiscal 1982 as compared to fiscal 1981. Shipments of PVC water pipe declined in both the current year and the prior year due to reduced residential construction activity.

Interest and other income amounted to $2.3 million for the current year, compared to $1.9 million the prior year and $1.2 million in fiscal 1980. Increased interest income in fiscal 1982 and fiscal 1981 is principally due to higher yields on short-term investments and higher average investments as compared to fiscal 1980. The $10.0 million, long-term financing obtained in November, 1980, along with continued sound cash management, accounted for this increase. Other income in fiscal 1981 included $209,000 in settlement of a class action suit against one class of our suppliers, which was initiated by other suppliers within our industry.

Costs and Expenses:

Gross profit percentage (the profit after deducting cost of sales from sales, expressed as a percentage to sales) is generally considered to be the key to profitability in the wholesale distribution industry. The severe decline in residential construction coupled with the highly competitive conditions within the Company's trading area had a significant impact on gross profit margins over the past two years. Gross profit expressed as a percentage to sales declined from 20.76% in fiscal 1980 to 20.02% in fiscal 1981 and 19.86% in fiscal 1982. Write-offs of obsolete inventory and inventory shortages in Marbut Company were significantly higher than anticipated, and contributed to the decline in gross profit percentage in fiscal 1982. The highly competitive nature existing within our industry, along with the volatile pricing structure of copper and PVC products, severely restricts your Company's ability to improve gross margins. The Company's Central Distribution Division (which purchases approximately 30% of the products sold by the wholesale division) enables your Company to obtain higher volume discounts; and, at the same time, maintain better control over inventory levels.

Selling, general and administrative expenses, expressed as a percentage to sales, was 14.8% in the current year, 13.5% last year and 13.4% in fiscal 1980. The higher ratio of selling, general and administrative expense is directly related to the higher operating costs of the Marbut Company branches and to inflationary pressures in almost all expense areas.

Payroll and payroll related costs increased 26.0% in fiscal 1982 as compared to fiscal 1981, while the comparable increase in fiscal 1981 was 13.5% and in fiscal 1980 was 13.4%. These costs, which approximate 60% of the total operating expenses, increased at a higher than normal rate in fiscal 1982, primarily due to the expense ratios of the Marbut Company operation.

The Company's contribution to employee benefit plans (Employee Stock Ownership and Employee Profit Sharing Plans) in fiscal 1982 was $934,500, in fiscal 1981 was $832,500, and was $700,000 in fiscal 1980. No contribution was made to Marbut Company's Profit Sharing Plan for the current year, however, Marbut Company employees participated in the Employee Stock Ownership Plan Contribution based on the terms of the Plan. Contributions to both bonus programs and employee benefit programs are based on certain levels of profitability. Bonuses paid under executive management and key employee programs was $532,000 in fiscal 1982, $515,000 in fiscal 1981 and $414,000 in fiscal 1980.

Advertising and sales promotional expense was $509,000 for the current year, $912,000 last year and $594,000 in fiscal 1980. Companywide sales promotional programs were first instituted in fiscal 1979 in conjunction with the Company's fiftieth anniversary.

Interest expense increased from $780,000 in fiscal 1980 to $928,000 in fiscal 1981 and to $1,971,000 in fiscal 1982. This increase was principally attributable to the interest expense on the $10 million long-term financing obtained in November, 1980.

The provision for bad debt expense was $892,000 in fiscal 1982, $331,000 in fiscal 1981 and $286,000 in fiscal 1980. Marbut Company accounted for $362,000 of this increased bad debt expense in fiscal 1982. The general economic conditions, high interest rates, and severe decline in housing starts, all had an effect on bad debt provisions for the current year. Management of your Company continues to stress sound credit policies, effectively administered. However, our policy of maintaining, or increasing, our market position during periods of economic decline and uncertainty tends to increase the risk factor as to potential write-offs of uncollectable accounts. Also, our policy is to vigorously pursue the collection of accounts previously written-off. With over 90% of the Company's sales being charge sales, a bad debt expense ratio of less than 0.5% of sales compares favorably with the overall average for our industry.

Net Income:

Net income for the current year decreased $1,248,000, or 19.5%, as compared to last year. Net income for fiscal 1982 was $5,157,000; in fiscal 1981 was $6,405,000; and, in fiscal 1979 was $5,942,000. Marbut Company's net loss included in this year's operating results was $1,060,000, or 85% of the decline in net income in fiscal 1982. Inventory and bad debt write-offs associated with the November 1, 1982 closing of the Marbut Company Birmingham branch accounted for approximately $175,000, or 17%, of the total Marbut Company net loss for the period. Inventory losses, bad debt write-offs, and generally poor operating results related to the depressed economic conditions prevailing in Marbut's trading area, all contributed to this loss. Net income expressed as a percentage to sales was 2.6% in fiscal 1982, 3.6% in fiscal 1981 and 3.9% in fiscal 1980. Net income per share was $2.34 in the current year, $3.12 last year and $2.92 in the prior year.

The manufacturing division reflected a significant increase in net income before income taxes in fiscal 1982. Pre-tax profit in the current year was $1,216,000, compared to $776,000 in fiscal 1981 and $1,179,000 in fiscal 1980. Both the Prestressed Concrete Manufacturing Division and Southern Mfg. Co. had improved operating results in fiscal 1982 compared to last year. The Universal 100 Products Manufacturing Division had poor operating results due to the continued highly competitive nature of the PVC water pipe market. Financial Information by Segments on Page 7 reflects sales, operating profit and asset information for both the manufacturing and wholesale divisions.

The effective tax rate for fiscal 1982 was 45.8%, compared to 46.8% in fiscal 1981 and 47.5% in fiscal 1980. Higher investment tax credit in fiscal 1982 ($319,000 in the current year, compared to $119,000 last year and $103,000 the prior year) was the most significant factor in the reduction of the fiscal 1982 effective tax rate. The cash flow benefits of the new accelerated cost recovery system of fixed asset depreciation are not included in the provision for income tax expense due to the offsetting provision for deferred income taxes.

Liquidity and Capital Resources:

As a wholesale distributor, the Company's liquidity is readily ascertainable, as approximately 80% of the Company's assets are comprised of cash and short-term investments, inventories and receivables. The composition of these assets over the last three years in reflected in the below table:

| | Percentage to Total Assets | | |
|---|---|---|---|
| | Fiscal 1982 | Fiscal 1981 | Fiscal 1980 |
| Cash and Short-Term Investments | 10% | 19% | 10% |
| Inventories | 41% | 40% | 44% |
| Receivables | 26% | 23% | 26% |
| Total | 77% | 82% | 80% |
| Other Assets | 23% | 18% | 20% |
| Total Assets | 100% | 100% | 100% |

Sales to End-User Markets (1)

| | Year ended January 29, 1982 | Year ended January 30, 1981 | Year ended January 25, 1980 |
|---|---|---|---|
| New residential construction | 25% | 30% | 40% |
| Utility and municipal expansion | 20% | 20% | 20% |
| Commercial and industrial construction | 40% | 35% | 25% |
| Replacement markets | 15% | 15% | 15% |

(1) Estimated by management.

The increase in cash and short-term investments in fiscal 1981 was primarily the result of the $10 million, fifteen (15) year, 12.375% financing obtained in November, 1980. The comparable $7 million reduction in fiscal 1982 was directly related to the acquisition and subsequent usage of working capital by Marbut Company.

Inventory turnover (based on the cost of sales as a ratio to ending inventory each year) has been approximately 4.3 times for each of the past three years. This is approximately 2½ months of inventory on hand on an annualized basis, which management feels is the necessary inventory needed to maintain adequate service levels for our customers. With the inventory composition and large percentage of purchasing done on a centralized basis, management is better able to maintain this inventory ratio in periods of both increasing and declining sales.

Receivables average 35-40 collection days on an annualized basis, and total receivables at year-end for each of the past three years have increased in almost direct proportion to the sales increases over the comparable periods. With the general poor economic conditions prevailing in the construction industry, greater emphasis is being placed on credit and collections in order to maintain this collection ratio and minimize our bad debt risk.

To recap the key components of working capital, which measures the Company's ability to meet its short-term obligations, total working capital at January 29, 1982, was $48,192,000; at January 30, 1981, was $46,566,000; and, at January 25, 1980, was $31,877,000. Current assets were equal to 334% of current liabilities at January 29, 1982, 312% at January 30, 1981 and 258% at January 25, 1980. Increases in working capital have generally been generated from current earnings other than in fiscal 1981 when $10 million was generated from long-term debt.

The Company feels that its present working capital and future earnings will be sufficient to internally finance planned growth over the next three to five years.

The Company has $7 million in existing lines of credit at prime rate with no compensating balances required and has had no short-term borrowing (other than the debt assumed on the Marbut Company acquisition which was immediately paid off) since July, 1974. These lines of credit, if needed would enable the Company to meet any short-term contingencies.

The Company's Stockholders' Equity was $50,709,000 at January 30, 1982, $43,045,000 at January 30, 1981, and $36,598,000 at January 25, 1980. Stockholders' Equity has increased $14,111,000 over the past two years (including stock issued), or an average of $7,055,500 on an annualized basis. The debt to debt-plus-equity ratio was 26% at January 29, 1982, 28% at January 30, 1981 and 18% at January 25, 1980.

At year-end the Company's stock was selling at substantially below the book value of $22.52 per share, which management attributes to poor market conditions and current projections for the construction industry in general. With improved and more stabilized economic conditions, management feels that the price of your Company's stock will benefit accordingly.

With total debt equal to less than 40% of stockholders' equity, long-term or short-term financing would be available to the Company, if needed. The present market conditions would not be favorable to the sale of equity securities.

Internally generated working capital over the past three years has been approximately $4.7 million. Externally generated capital has been $14.8 million, for a combined total of $19.5 million.

With this history of generating working capital and external financing available, your Company feels that it is in a strong financial condition.

Dividends:

The Company's first cash dividend was declared in the third quarter of fiscal 1977 and has been increased annually since that date.

The current annual cash dividend rate is $.40 per share, or $.10 quarterly.

Cash dividends of $845,000 were declared in the current year, as compared to $619,000 in fiscal 1981 and $451,000 in fiscal 1980.

Inflation and Changing Prices:

The impact of changing prices and inflation is extremely difficult to evaluate in our industry due to the volatile nature of various significant product categories, principally copper and PVC products, included in the Company's inventories which are of major significance to the Company's sales and profit margins.

A comprehensive cost comparison of inventory stock items at January 29, 1982 compared to the costs of the same items at January 30, 1981 indicated an overall cost increase of approximately 4.5%. The comparable analysis for the previous year indicated an overall cost increase of approximately 4%. Some categories reflected increases as high as 10%. In certain categories, such as copper and PVC products, there have been wide fluctuations in costs throughout the past three years.

In periods of declining building activity, such as now exists, there are extreme competitive pressures in pricing of most of the products sold by the Company. As best as management can estimate, inflation would account for no more than a five to seven percent annual increase in sales and in replacement costs of comparable inventories over the past three years.

Selling, general and administrative expenses have increased over the past three years in line with the general inflationary trend of the economy. As payroll and payroll related costs represent approximately 60% of these expenses, the Company has the ability to immediately react to changing conditions.

Since property, plant and equipment represent only approximately 20% of the Company's total assets and most of these properties, other than leased properties, have been purchased and/or constructed within the past five years, management believes that increased replacement costs would have little effect on the liquidity of the Company.

# APPENDIX A

## *Excerpt From* SECURITIES ACT RELEASE NO. 17114

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Form 10-K, as proposed, incorporated an entirely restructured Management's Discussion and Analysis. Additionally, this Item was moved from the Guides to become new Item 11 in Regulation S-K.

The major features of the proposed new Item were as follows:

(1) The discussion was to be focused on the financial statements and no longer centered upon a summary of operations. Indeed, as has been indicated above, the Summary of Operations would be eliminated.

(2) The proposed Item called for discussion of at least three financial aspects of the registrant's business—liquidity, capital resources, and results of operations.

(3) Within each area of the discussion there would be emphasis upon favorable or unfavorable trends and upon the identification of significant events or uncertainties.

(4) A discussion focused on individual segments would be required only if, in the registrant's judgment, it would be appropriate to an understanding of the registrant's business.

(5) Information concerning the effects of inflation and changing prices would be required.

(6) The percentage tests and line-by-line analysis encouraged by the present requirements contained in Guides 1 and 22[20] would be eliminated. However, the proposed Item indicated that the causes for material changes in line items should be discussed.

(7) The proposed Item would not specifically require projections or other forward-looking information, although the presentation of this type of information on a voluntary basis would be encouraged.

(8) No specific provisions with respect to the location of management's discussion in the annual report to security holders were included.

The changes in Management's Discussion and Analysis were proposed as the result of the Commission's concerns that the disclosure elicited by the present requirements of Guides 1 and 22 is not fulfilling originally contemplated objectives. Instead, existing percentage tests are applied without regard to any concept of materiality or significance to the registrant's business. Accordingly, although some portions of the resulting discussion may be meaningful, the meaningful discussion is often obscured by the inclusion of material which is of little relevance.

The Commission was also concerned that the focus of the requirements of Guides 1 and 22 may be too narrow. In today's environment there is a growing need to analyze an enterprise's liquidity and capital resources, in addition to its revenues and income. The narrow approach set forth in Guides 1 and 22 does not ordinarily produce a discussion which focuses upon the financial condition of the enterprise as a whole.

Finally, the Commission, as it has indicated on a number of occasions, was concerned about the adequacy of disclosures with respect to the impact of inflation and changing prices on indi-

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[20]Guides for Preparation and Filing of Registration Statements Under the Securities Act of 1933 (17 CFR 231.4936).

vidual registrants' businesses. Although the Commission does not believe that it would be appropriate at this time to expand the applicability of SFAS 33 beyond that established by the Financial Accounting Standards Board, it does believe that all registrants, including those which are not required to present SFAS 33 information, should make some textual presentation with respect to these matters. In this regard the Commission believes that Management's Discussion and Analysis should contain information which changes the potentially confusing situation involving inflation impact disclosure into a meaningful discussion of the effects of changing prices on the registrant's business.

The Management's Discussion and Analysis, as proposed, evoked extensive and diverse responses from the commentators. Some rejected it in its entirety, others endorsed it to the letter. Some felt that it was too specific and eliminated needed flexibility, others wanted more specific guidance. The main areas of concern, however, were three: First, there were various problems with the concepts of liquidity and capital resources; second, there was general disapproval of any disclosure requirements relating to inflation and changing prices; and third, there were various objections to those aspects of the Item which were seen as foward looking.

As was stated earlier in this release and in the proposing release, the Commission believes there is a growing need in today's environment to analyze enterprise liquidity and capital resources.[21] Therefore, the disclosure requirements concerning liquidity and capital resources have been retained, although in somewhat modified form. While the Commission recognizes that the terms "liquidity" and "capital resources" lack some precision in definition, it is believed that additional specificity would decrease the flexibility needed by management for a meaningful discussion. Moreover, the liquidity section has been revised to de-emphasize working capital and to emphasize the right and obligation of management to use whatever liquidity parameters they deem to be most appropriate.

In a similar manner, the Commission believes that disclosure on inflation and changing prices should be retained despite the early state of its development. Revisions have been made, however, to clarify that nothing more than SFAS 33 data is needed from those required to supply it and that the SFAS 33 type of detailed analysis is not necessary for those smaller registrants not required to comply with SFAS 33.

An effort also has been made to distinguish between those aspects of the Items which are entirely forward looking in nature, and hence encouraged but not mandated, and those mandated aspects which, although they look to the future, are basically present fact, such as a future labor cost increase established by an existing contract which will clearly increase future costs.

A number of other changes of a lesser nature have been made, often in response to specific comments. It is indicated that liquidity and capital resources discussions may be combined. Segment disclosure, if made, need not include every segment and registrants may use other breakdowns, such as company subdivisions, if investor understanding would thereby be improved. Causes of material changes in line items need be described only to the extent necessary to an understanding of a registrant's business as a whole. Foreign registrants are permitted to use their own country's version of SFAS 33, if it exists, and are required to discuss any governmental factors having a material impact on United States security holders.

Finally, as suggested in the proposing release, this new Item 11 of Regulation S-K is also being made a part of other Securities Act and Exchange Act forms (*See* Text of Amended Forms, Rules and Guides).

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[21]The Commission is aware of the Financial Accounting Standards Board's project on Funds Flows and Liquidity and does not intend to preempt that project in any way by proceeding with these new disclosure requirements. Moreover, the Commission intends to re-examine these requirements in the light of the findings of that project, when completed.

Item 11. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Discuss registrant's financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a), (b) and (c) of this section with respect to liquidity, capital resources, and results of operations, and should also provide such other information which the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations. Discussions of liquidity and capital resources may be combined whenever the two topics are interrelated. Where in the registrant's judgment a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of such business, the discussion should focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole.

(a) *Liquidity.*

Identify any known trends or any known demands, commitments, events or uncertainties which will result in or which are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action which the registrant has taken or proposes to take to remedy the deficiency. Identify and separately describe internal and external sources of liquidity, and briefly discuss any material unused sources of liquid assets.

(b) *Capital resources.*

Describe the registrant's material commitments for capital expenditures as of the end of the latest fiscal period, and indicate the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments.

Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected material changes in the mix and the relative cost of such resources. This discussion should consider changes between equity, debt and any off-balance sheet financing arrangements.

(c) *Results of operations.*

Describe any unusual or infrequent events or transactions or any significant economic changes which materially affected the amount of reported income from continuing operations and, in each case, indicate the extent to which income was so affected. In addition, describe any other significant components of revenues or expense which, in the registrant's judgment, should be described in order to understand the registrant's results of operations.

Describe any known trends or uncertainties which have had or which the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations. If the registrant knows of events which will cause a material change in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments) the change in the relationship should be disclosed.

To the extent that the financial statements disclose material increases in net sales or revenues, provide a narrative discussion of the extent to which such increases are attributable to increases in prices or to increases in the volume or amount of goods or services being sold or to the introduction of new products or services.

For the three most recent fiscal years of the registrant, or for those fiscal years beginning after December 25, 1979, or for those fiscal years in which the registrant has been engaged in business, whichever period is shorter, discuss the impact of inflation and changing prices on the registrant's net sales and revenues and on income from continuing operations.

**Instructions.**

1. The registrant's discussion and analysis shall be of the financial statements and of other

statistical data which the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition and results of operations. Generally, the discussion should cover the three year period covered by the financial statements and should utilize year-to-year comparisons or any other formats which in the registrant's judgment enhance a reader's understanding. However, where trend information is relevant, reference to the five year selected financial data appearing in Item 10 of Regulation S-K may be necessary.

2. The purpose of the discussion and analysis should be to provide to investors and other users information relevant to an assessment of the financial condition and results of operations of the registrant as determined by evaluating the amounts and certainty of cash flows from operations and from outside sources. The information provided in this Item 11 need only include that which is available to the registrant without undue effort or expense but which does not clearly appear in the registrant's financial statements.

3. The discussion and analysis should specifically focus on material events and uncertainties known to management which would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include description and amounts of (a) matters which would have an impact on future operations and have not had an impact in the past, and (b) matters which have had an impact on reported operations and are not expected to have an impact upon future operations.

4. Where the consolidated financial statements reveal material changes from year to year in one or more line items, the causes for the changes should be described to the extent necessary to an understanding of the registrant's businesses as a whole; *provided, however,* if the causes for a change in one line item also relate to other line items, no repetition is required and a line-by-line analysis of the financial statements as a whole is not required or generally appropriate. Registrants need not recite the amounts of changes from year to year which are readily computable from the financial statements. The discussion should not merely repeat numerical data contained in the consolidated financial statements.

5. The term "liquidity" as used in paragraph (a) of this Item refers to the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash. Except where it is otherwise clear from the discussion, the registrant should indicate those balance sheet conditions or income or cash flow items which the registrant believes may be indicators of its liquidity condition. Liquidity generally should be discussed on both a long-term and short-term basis. The issue of liquidity should be discussed in the context of the registrant's own business or businesses. For example, a discussion of working capital may be appropriate for certain manufacturing, industrial or related operations but might be inappropriate for a bank or public utility.

6. Registrants are encouraged, but not required, to supply forward-looking information. This is to be distinguished from presently-known data which will impact upon future operating results, such as known future increases in costs of labor or materials. This latter data may be required to be disclosed. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. See Securities Act Release No. 6084 (June 25, 1979) [44 FR 38810].

7. Registrants which are required to provide narrative explanations of supplementary information disclosed in accordance with paragraph 37 of SFAS 33 may combine such explanations with the registrant's discussion and analysis required pursuant to this provision or may supply such information separately. If such statement is combined, the supplementary information required by SFAS 33 shall be located in reasonable proximity to the discussion and analysis. If such statement is not combined the discussion of the impact of inflation otherwise required by this item may be omitted but an appropriate cross reference to the explanation required by paragraph 37 of SFAS 33 shall be made. Foreign registrants need not comply with SFAS 33 but if, in its home country, a foreign registrant must satisfy requirements that are analogous to SFAS No. 33, then such analogous presentation shall be given.

8. Registrants which are not required to provide explanations of supplementary information disclosed in accordance with SFAS 33 (including foreign private registrants) may discuss the effects of inflation and changes in prices in whatever manner appears appropriate under the circumstances. Although voluntary compliance with SFAS 33 is encouraged, it is not required. All that is required is a brief textual presentation of management's views. No specific numeric financial data need be presented.

9. All references to the registrant in the discussion and in these instructions shall mean the registrant and its subsidiaries consolidated.

10. Foreign private registrants should also discuss briefly any pertinent governmental economic, fiscal, monetary, or political policies or factors which have materially affected or could materially affect, directly or indirectly, company operations or investments by United States nationals.

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# APPENDIX B

# CODIFICATION OF FINANCIAL REPORTING POLICIES

## 500 INFORMATION OUTSIDE OF FINANCIAL STATEMENTS

### 501 Management's Discussion and Analysis

[In ASR 159, the Commission adopted Securities Act Guide 22 and Exchange Act Guide 1 which required that registration statements and annual reports filed with the Commission include a narrative explanation of the summary of earnings. In ASR 279, adopted September 2, 1980, the Guides were rescinded and the discussion requirements were moved to Regulation S-K (currently Item 303) and were substantially revised and expanded to address the financial statements as a whole. In September 1981, the Commission issued ASR 299, which was an interpretive release giving staff commentary and examples to assist registrants in preparing the MD&A. Guidance offered by the staff is reprinted below to assist registrants in developing their MD&As. Although the examples noted in the release were appropriate when the release was issued, it is believed that as registrants become more familiar with the application of the MD&A requirements for their particular situation and with the overall MD&A philosophy the examples will not be as useful. Thus, the examples have not been reprinted below.]

### .01 Introduction

**ASR 299:**

The Commission was concerned that the previously existing management's discussion and analysis of the results of operations had developed into an often mechanistic commentary on percentage variations. Thus, it was not fulfilling its originally contemplated objective of providing investors with a realistic management assessment of corporate objectives and numerical results. Moreover, the focus on operations alone was insufficient to cover all aspects of an enterprise's financial situation in today's complex economic environment. Consequently, the revised requirements requested information on financial condition as well as operations, with an emphasis on liquidity, capital resources and the impact of inflation, and, within each of those areas, a focus on trends and material changes, events and uncertainties. In order to allow registrants to discuss their businesses in the manner most appropriate to individual circumstances and to encourage flexibility, the provisions were intentionally general and offered a minimum of specific requirements.

The staff had the opportunity to review a number of examples of MD&A from 1980 annual reports. Based on the review, the staff issued this release to discuss its assessment of the initial responses to this requirement. However, it is the responsibility of management to identify and address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the individual company.

### 501.02 Summary Evaluation of Responses

**ASR 299:**

In line with the flexibility in the wording of the release, the MD&A sections varied considerably in content, format and extent of coverage. Overall, the staff noted major improvement in the quality of management's discussion of the results of operations. Many registrants focused their analysis on segment data and information about significant events and trends, resulting in presentations which were generally more readable and informative than previous mechanical discussions of percentage line item changes. As to the new requirements to discuss financial condition and changes in financial condition, registrants provided considerably more information than in the past, in a variety of formats. There were also discussions of other economic, industry and specific company factors and uncertainties relevant to an accurate understanding of the company's operations and financial condition. The staff encourages registrants to continue to address such matters. Of particular importance are factors which are expected to make reported historical results and trends either indicative or not indicative of future operating results and related financial condition. Thus the regulations specifically state that the MD&A should discuss known trends and describe any matters which have had an impact on past operations but are not expected to continue to do so, as well as any matters expected to impact future operations even though they have not had an impact in the past.

The rules encourage, but do not require, forward-looking disclosures. The staff was pleased that a number of registrants elected to include such information. Forward-looking disclosures were most frequent in the area of expenditures, which are by nature future oriented. However, certain registrants also provided forward-looking information with respect to operations and liquidity. The disclosures, which varied from brief comments to broader discussions, including in some cases a five-year forecast of revenues and cash flow, demonstrated that the discussions need not be quantitative to be meaningful.

### 501.03 Results of Operations

**ASR 299:**

As mentioned above, registrants made much progress in the form and content of their 1980 discussion of the results of operations, particularly in redirecting the general thrust of the discussion to an analysis of the reasons for and implications of reported results. The staff found that where discussions in terms of three- and five-year trends, as well as segment disclosures, were included, they were generally very informative and encourages more widespread use of these formats.

Certain registrants also provided meaningful discussion of the implications of significant events or uncertainties which were expected to materially impact future operations, for instance, the decontrol of U.S. oil prices, the proposed Canadian oil production taxes and price restrictions, or, for railroads, the Staggers Act. The staff emphasized the need to identify and discuss such significant events whether they be internal or external to the company.*

### 501.04 Liquidity and Capital Resources

**.a General Concept**

**ASR 299:**

Item 303 defines liquidity as "the ability of an enterprise to generate adequate amounts of

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*Although the regulations state that the MD&A need not repeat information included in the financial statements, it would be necessary for the MD&A to analyze any material implications of matters concerning the company's operations, liquidity or resources, which are merely described in the basic financial statements. The description, however, need not be repeated.

cash to meet the enterprise's needs for cash." As pointed out in the item, liquidity has both short-term and long-term aspects. It involves internal as well as external sources and is often closely associated with an enterprise's capital resources. The rules thus provide that the discussions of liquidity and capital resources may be combined when the two topics are interrelated.

Although the Item draws a distinction between liquidity and capital resources, in 1980 many registrants interpreted liquidity not merely as interrelated with capital resources, but as *encompassing* capital resources. The release therefore discussed the two topics together.*

The staff emphasized that the liquidity information should serve to assist users in evaluating a company's ability to generate cash to meet cash needs both currently and in the future. The scope of the discussion should thus address liquidity in the broadest sense, encompassing internal as well as external sources, current conditions as well as future commitments and known trends, changes in circumstances and uncertainties. From this perspective, the discussion of liquidity goes beyond a simple review of current assets and liabilities at a given date. For both the short term and the long term, it should compare assured available resources to expected requirements and address any identified deficiencies as well as the course the issuer intends to take to meet such deficiencies.

Existing sources of liquidity include cash balances and assets readily convertible to cash as well as current operating cash flows. The narrative should describe how known trends, changes in circumstances or significant events may impact operating cash flows, making past results indicative or not indicative of the future. Any other factors significant to individual companies or industries should also be discussed.

Last, the discussion of liquidity should describe the registrant's liquidity requirements and, where deficiencies are identified, address the available remedies. Issuers are encouraged to include in such discussions of remedies a description of any anticipated cash resources, such as potential cash flows from expanded levels of operations, additional external financing or sale of nonoperating assets. Liquidity requirements vary among industries but include demands such as capital expenditures (including any off-balance sheet commitments), expanded working capital needs, or scheduled debt repayments. Throughout the discussion of liquidity, it is also necessary to identify those balance sheet, income and cash flow items believed to be indicators of liquidity. The discussion will be enhanced by an explanation of the reasons why particular indicators are appropriate for the individual registrant. In this sense, unused credit lines, debt-equity ratios, bond ratings, and restrictions under existing debt agreements may be indicators of liquidity.

The staff also encourages registrants to identify and discuss those factors relevant to an understanding of the company's future objectives, plans and its ability to complete those plans. Anticipated sources of financing are particularly important to capital intensive enterprises where *planned* expenditures also are many times more meaningful than legal commitments. Similarly, the anticipated cost of capital as well as its expected availability may be a key consideration for highly leveraged companies.

### 501.04.b Evaluation of Disclosures

**ASR 299:**

The 1980 disclosures which the staff reviewed concerning short-term liquidity generally addressed working capital, a concept with which companies are familiar and comfortable, fre-

*When viewed to encompass capital resources, the Commission's concept of liquidity is comparable to the FASB's concept of *financial flexibility* or the ability of an enterprise to adjust its future cash flows to meet needs and opportunities, both expected and unexpected. Financial flexibility is broader than the FASB's concept of liquidity (defined as short-term nearness of assets and liabilities to cash) because it includes potential internal and external sources of cash not directly associated with items shown on the balance sheet. (See FASB Discussion Memorandum, "Reporting Funds Flow, Liquidity and Financial Flexibility", December 15, 1980, pp. 88, 107.)

quently supplemented only with information on funds flow from operations computed on a working capital basis. The staff urged companies to be certain that the discussion be sufficiently expansive to fully address the subject of liquidity since the ability to generate cash to meet cash needs generally depends upon a more extensive group of factors than working capital alone.*

For that reason, it is often necessary to expand the discussion to include cash flow from operations and other sources. In this sense, the concept of cash flow from operations should not be limited to net income adjusted for noncash charges and credits, but should also consider changes in the relevant components of working capital—such as receivables, payables and inventory. Cash flow from operations, thus computed, is an especially helpful indicator, and the staff encourages its display as a three-year trend. It should be noted that this measure is frequently very different from "funds flow from operations" computed on a working capital basis and the captions should not be used interchangeably.

Besides cash flow from operations and related working capital considerations, assessments of liquidity should, as discussed above, include consideration of matters such as the following:

- Available unused sources of financing, including existing lines of credit, ease of access to markets, and convertibility of noncurrent assets to cash.
- Trends in liquidity and known commitments.
- Known or likely deficiencies and remedies.
- Significant events and uncertainties, including flexibility to adapt to change.

### 501.05 Inflation Disclosures

#### .a General

**ASR 299:**

Although the provisions of SFAS 33 apply only to companies meeting certain size criteria, the Commission believes that management for all registered companies should focus on translating the potentially confusing situation concerning inflation into a meaningful discussion of the effects of changing prices on the registrant's business.

Consequently, Item 303 requires that registrants include at least a narrative discussion of the effects of inflation and changing prices. For companies not subject to the provisions of SFAS 33, voluntary compliance with SFAS 33 is encouraged but not required. The Commission's objective is to elicit useful disclosures concerning the impact of inflation without imposing an undue computational burden. Registrants required to include SFAS 33 disclosures are allowed simply to provide a cross reference to the location of such information.

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*Working capital (current assets less current liabilities) may potentially mask both the uncertainty and timing of the conversion of current assets to cash. It also fails to give credit for strict cash management techniques which deliberately minimize current assets in relation to current liabilities or to consider the impact of unused available short-term credit or of inventory costing techniques, such as LIFO, which may greatly understate inventory values in inflationary periods. Thus, alone, it may significantly misrepresent a company's liquidity position. For example, disclosure that a company's ratio of current assets to current liabilities is 3:1 could lead the reader to assume that the company has ample ability to generate cash to meet its obligations in a timely manner. If, however, the current assets consist of 10% cash, 50% receivables and 40% inventory, with approximately 3/4 of the inventory in raw or uncompleted form, it may be necessary to know turnover rates to evaluate the company's cash position accurately. A recent example of a situation in which a company's working capital position failed to reveal its cash flow problems was the W. T. Grant Company, which filed for Chapter XI on October 2, 1975. Despite positive working capital positions, cash generated by operations had in fact been negative for its last five years.

Similarly, discussions of working capital provided from operations, as that number is shown on the funds statement, can give rise to the erroneous concept that noncash charges to income, such as depreciation, are sources of liquidity.

### 501.05.b Impact of Inflation on Sales

[Three examples were presented demonstrating (1) information on price/volume mix, (2) inability of selling prices to keep pace with inflation and (3) presentation of constant dollar sales information.]

### 501.05.c Impact of Inflation on Monetary Assets and Liabilities

**ASR 299:**

Monetary assets and liabilities represent claims to receive or obligations to disburse fixed amounts of cash. They include cash and most receivables and payables. During an inflationary period, companies experience purchasing power gains from holding net monetary liabilities and losses from holding net monetary assets. Where material, it is suggested that registrants discuss their net monetary position and any corresponding purchasing power gains and losses.

### 501.05.d Impact of Inflation on Inventory and Cost of Sales

**ASR 299:**

Generally accepted accounting principles require companies to use historical costs in valuing their inventories and cost of sales. In periods of changing prices, these historical costs will differ from the current costs of inventory. The nature and extent of the distortion depends upon the cost allocation method selected by the company. Under the FIFO method, the oldest inventory costs flow to cost of sales, with the most recent costs remaining in inventory. Cost of sales thus tends to be understated. The LIFO method reverses this pattern and generally results in understated inventory balances.* Where such distortions are material, companies should indicate their existence and direction. Regulation S-X requires companies using the LIFO method to indicate by footnote disclosure the replacement cost of inventory. Most companies approximate this amount by reference to the FIFO valuation of their inventory. The staff encourages companies to refer to this computation in the discussion and analysis section.

### 501.05.e Impact of Inflation on Plant Assets and Depreciation

**ASR 299:**

Under generally accepted accounting principles, companies record plant assets at actual cost and allocate these costs to income over the assets' useful lives. During inflationary periods, therefore, depreciation charges are understated and net income overstated to the extent that the current costs of plant assets exceed original costs.

To reflect this situation, SFAS 33 requires the largest companies to indicate in a supplemental note the current costs of plant and depreciation. The Commission does not require such calculations by non-SFAS 33 companies, but does encourage at least some narrative discussion of the extent of the difference between historical cost and current cost. Information on relative asset ages can also assist users in developing their own estimates of price-adjusted amounts.

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*In those periods in which sales exceed purchases, the older costs from beginning inventory flow to cost of goods sold, understating that figure.

### 501.05.f Impact of Inflation on Financial Intermediaries

**ASR 299:**

Inflation substantially impacts the financial position and operations of financial intermediaries, such as banks, savings and loan companies and finance companies. These entities primarily hold monetary assets and liabilities and, as such, can experience significant purchasing power gains and losses over relatively short periods of time. In addition, interest rate changes during inflationary periods change the amounts and composition of assets and deposits held by financial intermediaries and often result in creditor and regulatory pressures for additional equity investment.

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