NEED FOR PRODUCT-LINE REPORTING

A View from the Securities and Exchange Commission

Presented by

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at

Symposium on Financial Reporting

for Conglomerates

Tulane University

Graduate School of Business Administration

New Orleans, Louisiana

November 13, 1967

The invitation to participate in this symposium on product-line reporting by "conglomerate" corporations was addressed to Chairman Cohen with an impressive prospectus, including a quotation from his address before the American Institute of Certified Public Accountants in Boston over a year ago.[1] In the quoted passage a reference to a sense of urgency in dealing with this subject was underscored. Since that time, and for some months before, the subject has been on the agenda for consideration by trade associations and professional organizations and has been a popular topic for financial writers. And now, at this meeting, the sponsors are confident that our discussions will serve as an effective complement to the major study of the entire issue of financial reporting by "conglomerates" launched by the financial Executives Institute.

The FEI study, which Dr. Robert Mautz of the University of Illinois is making, will meet a commitment to the SEC made by the FEI before Chairman Cohen spoke in Boston. The study is directed by an administrative committee of the FEI and progress is reported periodically to an advisory board composed of representatives of organizations which are interested in the success of the project. Interim reports by Dr. Mautz have appeared in the July and September 1967 issues of the Financial Executive and a third appears in the current November issue. These reports deal with the subjects of "Identification of the Conglomerate Company," "Conglomerate Reporting and Data Reliability," and "Bases for More Detailed Reporting by Diversified Companies."

The diversity of interests represented by the participants in the program for today and tomorrow should serve to encourage Dr. Mautz in his work and conceivably could

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

raise questions requiring answers before he summarizes his results. For myself, I find I am among friends of long standing even though we may not agree at all times on all accounting matters.

As background for our discussion today, a glimpse into the past may be in order. At the beginning of this century corporate managements and independent accountants were faced with the problem of reporting on the expansion of industrial empires through vertical as well as horizontal integration. And the literature of those days seems to indicate that different kinds of enterprises were brought together under holding companies.

Montgomery dealt with the subject in the first edition of "Auditing Theory and Practice" in a chapter of ten pages on holding companies.[2] The chapter opens with the sentence, "In the face of the Sherman Act, business combinations are being formed daily." Montgomery said that the balance sheet published by a holding company of that day was "wholly devoid of the information an investor or stockholder seeks" and frequently was prepared in a misleading manner. He used even stronger language in denouncing the legal argument that the holding company should report in its profit and loss account only the dividends received from subsidiaries during the period. "This sounds well in theory," he said, "but in practice it is the argument of dishonest men." He points out that this theory of reporting permitted management to conceal losses of some subsidiaries while reporting dividends from others, thus condoning various possibilities for deceiving stockholders. Examples are cited. Montgomery concluded that "Wherever a holding company owns and controls one or more subsidiaries, the profits or losses of

[2] Montgomery, Robert H., "Auditing Theory and Practice," Chapter XXX, The Ronald Press Company, New York, 1913.

the subsidiaries must be stated for the same period as that of the holding company and consolidated. Any other method may lead to gross abuse."

This early and very brief discussion carries within it an endorsement of the equity method of accounting for investments in subsidiaries only recently fully supported by the Accounting Principles Board in its Opinion No. 10 through an amendment of Accounting Research Bulletin No. 51 on "Consolidated Financial Statements." Montgomery also laid down in no uncertain terms a rule of practice which the SEC found it necessary to reiterate in an amendment to the proxy rules three and one-half years ago. The amended rule in effect warns managements that too much flexibility in principles of consolidation could not be tolerated. It requires that "consolidated financial statements of the issuer and its subsidiaries shall be included in the report [to stockholders] if they are necessary to reflect adequately the financial position and results of operations of the issuer and its subsidiaries . . ."[3]

I have started with this brief comment on consolidated statements to emphasize at the outset that despite our recognition of the growing need for information about the segments of a conglomerate enterprise, we do not underrate the continuing need for properly prepared consolidated financial statements to report the overall financial condition and results of operations of the enterprise in which the investor has an interest.

An examination of current guidelines, including Article 4 of the SEC's Regulation S-X, for the preparation of consolidated financial statement discloses, I think, that the current consideration of reporting on the various segments of an affiliated group of companies involves an extension of a long standing practice rather than a completely new

[3] Rule 14a-3, Securities Exchange Act of 1934.

idea. Our regulations are stated in broad terms similar to the passage I have quoted from the proxy rules. These include a warning to consider carefully the propriety of consolidating foreign operations affected by adverse conditions and a requirement that, if majority-owned subsidiaries are omitted from consolidation for valid reasons, financial statements of these omitted subsidiaries, consolidated or combined in an appropriate manner, shall be filed if essential to a properly summarized presentation of the facts. We endorse the equity method of accounting in the parent and consolidated statements for such omitted subsidiaries. With certain exceptions, the rules prohibit inclusion of insurance companies and banks in consolidation with industrial and commercial companies. If material, separate or combined statements, as appropriate, of such companies are required. There are differences of opinion in accounting circles as to when captive finance companies should be included. Current AICPA bulletins support our view that real estate companies which own property used by the parent should be included in consolidation. Many of the large finance companies have diversified their operations by acquiring manufacturing and merchandising companies. The separate character of these companies has been disclosed for many years--long before the present active discussion of the "conglomerate" company problem.

Experience in requiring compliance with the Commission's existing reporting requirements indicates the need for our present study. A report on Form 8-K under the Securities Exchange Act of 1934 is required to be filed upon the occurrence of certain events. One of these events is the acquisition of a business. If material with respect to the registrant, financial statements for the acquired business must be furnished. Considerable resistance to furnishing such financials is expressed when the acquisition is of a closely held single product company, often quite different from the acquiring company's business. It is argued that only at this one time will details of the operations of the single product business ever be disclosed, because after acquisition its operations will be included in the consolidated financial statements. The purpose of the disclosure requirement, of course, is to provide information for the stockholders of the acquiring company by which they may judge the actions of their management. The present materiality test here is 15% of assets or revenues of the registrant. A current proposal would reduce this to 10%. Should continued disclosure of the operations of the acquired company be required under some similar test?

Rules under the Securities Exchange Act also require the filing of semi-annual reports of profit and loss and earned surplus information. The rules are pursuant to a provision of the act which was first implemented at the close of World War II to require at that time the reporting only of gross revenues as an indication of the effect on the company of the end of the war. Later, financial analysts sought interim net income as well as revenues. Noting that in many cases as volume of business went up net income went down, the Commission rescinded as inadequate the requirement for volume only reports and adopted requirements for the present form of a simple mid-year income statement. This experience is pertinent to our present inquiry, as I will show in a few minutes.

Registration Forms 10 and S-1 require the registrant to give a description of the business. Similar instructions under both forms specify that "If the business consists of the production or distribution of different kinds of products or the rendering of different kinds of services, indicate, insofar as practicable, the relative importance of each product or service or class of similar products or services which contributed 15% or more to the gross volume of business done during the last fiscal year." It should be noted here that at the end of 1966 the Financial Executives Institute urged its members to give a breakdown of sales in their reports to stockholders. Our review of the 1966 reports showed a substantial improvement in the disclosure of such data over the prior year. It should also be noted that, whereas our instruction in these forms refers to the last fiscal year, prospectuses (and reports to stockholders as well) often include tables showing the composition of sales by major product lines for a period of years.

If you will recall my reference to the inadequacy of reporting sales alone, certain words in the Form 10 and Form S-1 instruction become significant. The instruction calls for an indication, "insofar as practicable," of "the relative importance of each product or service or class of similar products or services . . ." Except by a fortunate coincidence sales alone will not answer this question of relative importance. Hence the staff and, as I have observed, enlightened managements in their reports to stockholders have sought to answer this question in some manner. Some examples may demonstrate the point although it hardly needs elaborate discussion.

The January 3, 1967, edition of the Wall Street Journal carried a "Letter to Stockholders" from Wilson & Co., Inc. which included a table identical to the one in the report to stockholders issued a week later. This table, as given below, was in each case introduced by a statement that each of the three divisions of the company had higher sales and earnings than the year before:

	MILLIONS			
	1966		1965	
	Sales	Net Earnings	Sales	Net Earnings
Meat and Food Products………	$875	$ 7.7	$731	$ 4.9
Athletic Goods………..………	80	3.7	73	3.1
Chemical Industries…………...	36	1.5	29	1.3
	$991	$ 12.9	$833	$ 9.3

A recent prospectus includes information in table and text which can be reported in a single table for quicker comprehension:

> Percentages of total dollar sales of principal product groupings and contributions of such product groupings to consolidated net income were:

Product Group (Described in text)	1964 Sales	1964 Income	1965 Sales	1965 Income	1966 Sales	1966 Income
A	56%	80%	56%	83%	48%	70%
B	26%	20%	24%	10%	22%	18%
C	18%	0%	20%	7%	30%	12%

This example warrants further comment. The question of consistency and comparability of financial statements from year to year for each company and for companies in the same industry is a popular subject for discussion today--as it has been for about as long as I can remember. This example is taken from one company in over sixty in its very important industry which file firnancial statements with the Commission. I doubt very much if any two of these companies are enough alike to say that the same breakdown would be pertinent to each. Individual characteristics of each should be brought out for the financial analyst and investor to consider. Tables of figures without the basis for informed judgment are not likely to be useful.

Just in case it has not come to your attention, in England the Companies Act 1967 amends prior acts to require that directors' reports in respect of financial years ending on or after the 27th of July 1968 include:

> "Analysis of turnover and profit or loss before taxation of the company, or in the case of a holding company submitting consolidated accounts, of the group, between substantially different classes of business, stating, unless turnover is not required to be disclosed in the accounts [instructions omitted]:
>
> (a) the proportions in which the turnover is divided amongst those classes (describing them)
>
> (b) the extent or approximate extent (expressed in monetary terms) to which, in the opinion of the directors, each class of business has contributed to, or restricted, the profit or loss of the company for the year before taxation."[4]

The topic before us has attracted a great deal of attention and vigorous favorable as well as adverse comment. Since my role here today is to support a reasonable interpretation of our disclosure requirements, which we deem to require some clarification as to conglomerate companies, some supporting comment may be appropriate here.

We have noted many comments citing the benefits of and the need for additional disclosures by diversified companies, which were made by a rather wide range of writers. These include corporation executives, financial analysts, professors, public accountants and individual investors, as well as many general financial writers.

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[4] See "Guide to the Accounting Requirements of The Companies Acts 1948-1967," page 25, Published for the General Educational Trust of the Institute of Chartered Accountants in England and Wales by Gee & Co. (Publishers) Limited, London, England.

For the most part, as might be expected, the comments have stressed the needs of investors for the additional information. The following, by an investment analyst, is illustrative:

> "…the conventional tools of investment analysis fail to provide adequate answers to an investor or stockholder when dealing with a conglomerate company which does not disclose major divisional operations. To assess the individual importance of a hodgepodge of products and their impact on sales and earnings of a company is often impossible without proper published information."[5]

On the other hand some corporate executives have indicated that they believe their corporations also benefit by such disclosure. A financial vice president of a company that provides an informative breakdown of net income stated that this allocation "has been extremely helpful to me in building relationships with security analysts." He indicated that he was convinced that the breakdown is of value to the individual investor as well as to the professional analyst, and said: "We would rather provide a fair presentation of the data than have him guess. We have found that it builds a certain amount of confidence."

The Commission's record in this matter has been stated repeatedly at various professional meetings--most recently at the annual meeting of the Financial Executives Institute in Montreal. On that occasion I dealt with a few misconceptions of our views which have come to our attention. Since those remarks appear in the November issue of the Financial Executive they need not be repeated here.

In 1965 the Commission responded to an inquiry from Senator Philip A. Hart, Chairman, Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary. This response which covers some of the matters I have mentioned this morning as well as a brief recital of some of the accounting problems involved in product-line reporting may

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[5] "Economic Concentration," Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, United States Senate, Part 4, page 1706.

be found at page 1069 of Part 2 of the record of hearings of this subcommittee published under the title of "Economic Concentration." Chairman Cohen, when called to testify before Senator Hart's subcommittee on September 20, 1966, referred to this memorandum and then said:

> "Up to now, however, except in the case of companies selling both goods and services, we have had no general requirement that conglomerate companies break down their financial statements to show results of operations for their different divisions. As our 1965 memorandum set forth, there are a number of reasons why we did not do so. But changes have been occurring recently which have made it necessary for us to reconsider our requirements in this area despite the difficulties we will have to face.
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> "The most important change, as you are of course well aware, is the growing tendency toward absorption of separate industrial enterprises into large conglomerate companies. Each time one of these enterprises is absorbed, and ceases to publish separate financial statements, the available information about the industry in which that enterprise is engaged is correspondingly reduced. Acceleration of the trend toward absorption of these independent enterprises makes it increasingly difficult for investors and others to draw intelligent conclusions about the affairs and prospects of companies in the particular industries and this, of course, applies even to the conglomerate companies or to independent companies. Now, this creates a very real threat to the ability of independent investors to reach informed investment decisions, which Congress has recognized as a basic prerequisite to a healthy securities market and which philosophy underlies all of the securities statutes administered by the Commission."[6]

This states the SEC's view.

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[6] "Economic Concentration, " op. cit., Part 5, page 1983.