

COMMENTS ON THE CONGLOMERATE PROBLEM

by

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My comments today relate to two somewhat opposing aspects of the conglomerate problem--adverse reactions that we have noted, on the one hand, and progress toward a solution, on the other.^{1/}

Although the Chairman of the Securities and Exchange Commission and I have spoken and written extensively on the subject of the need for and the problems of additional disclosures on the diversified operations of companies--in public addresses, in conferences with individuals and groups, and through correspondence--we still note what we consider to be misconceptions about the SEC position and what we believe to be unjustified doubts or fears on the problem in general.

I would like to take this opportunity to discuss some of these matters in an attempt to correct the misconceptions and to allay the doubts and fears. In discussing these problem areas I do not want to give the impression that we have not received any favorable comments. There have been many, which is quite encouraging. However, I believe that further efforts to dispel the unfavorable reactions, such as those noted below, will contribute to progress toward agreement on an equitable solution to the problem.

ITEM - There have been a number of comments which indicate that the writers believe that the SEC has already determined specific requirements for more detailed reporting that will be prescribed. The following comment is illustrative: "The Commission is considering requiring reports in detail on revenues, costs and profits for each product class, geographic area and successive stages of manufacturing and distribution."

^{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.

Other comments have indicated that the SEC has set deadlines for establishing requirements or is saying "Hurry, hurry, hurry!" in regard to the studies of the problems involved which are being conducted by the professions.

As recently as June I had commented in a public address ^{2/} on these matters to the effect that we have not as yet developed criteria for additional detailed reporting, and we do not expect to reach a conclusion until we have had time to evaluate the results of these studies and to consider all the comments that are submitted to us. This is still our position. At the same time we wish to develop a solution at the earliest feasible time. The Chairman has indicated on a number of occasions that these studies should be approached with a sense of urgency. But the expression "Hurry, hurry, hurry!" that we hear implies that we are urging speed at the expense of adequacy and thoroughness in the studies. This is not the case. The Chairman's letter of August 14 to Mr. Nagel in acknowledging his progress report gives a clear perspective, I believe, of the importance of the problem, the significance of the FEI study to date, and the need for expeditious action in completing the work.

ITEM - Another comment that we hear is that any additional breakdowns of financial information would be misleading to investors; in part, because of problems of allocation of joint costs and inter-company transfers; and, in part, because of widely differing accounting principles and practices which are applicable in general to financial accounting. One writer concluded that, because of this, compulsory uniform accounting systems would probably be imposed to make such breakdowns not misleading.

^{2/} Address at Annual Conference of National Association of Accountants, June 27, 1967.

Variations of this comment are that any system of compulsory reporting would result in the investor receiving information which would be less than useful and, in fact, in many cases misleading, or compulsory reporting of this type would in most cases be disadvantageous and in some cases disastrous to the shareholders.

We have always recognized the problems of cost allocations and inter-company transfers. It was in recognition of the practical problems involved that the Chairman spoke in terms of "a defined operating profit and loss statement on a divisional basis as the next objective beyond the breakdown of sales for the conglomerate company" in a speech in May 1966.^{3/} We hope that your study, and others, will provide sufficient information in these areas to enable us to define the "defined profit" more precisely but not necessarily the same for all companies. However, some writers seem to over-emphasize these problems and give the impression that they will be serious for every diversified company and will thus prevent any extension of the reporting requirements. We take a somewhat less pessimistic view. No doubt some companies will be affected by such problems but, in any event, we believe that equitable solutions can be developed that will permit reasonable extension of the requirements.

The arguments that differing accounting methods in general use today would make the conglomerate reporting misleading is not a valid one, in my opinion. For overall company financial reporting purposes the existing alternative accounting practices are disclosed. No different problems will exist in conglomerate reporting and, in fact, as one writer has said, ". . . more detailed reporting will make it possible to indicate the accounting methods employed by the various product lines, so as to facilitate analysis

^{3/} Address at Annual Conference of the Financial Analysts Federation, May 24, 1966.

of consequences."^{4/} The Chairman expressed his concern regarding the danger of investors receiving misleading information in testimony in 1966 before a Senate Subcommittee on Antitrust and Monopoly in the following words:

"We also must be extremely careful, in our desire to achieve maximum disclosure of divisional results, not to encourage disclosures which may mislead investors by appearing to be more meaningful than they really are. One problem in this area is the extent to which we can achieve uniformity or, at the least, comparability in divisional reporting."^{5/}

The assumption that compulsory uniform accounting systems would be required in the future because conglomerate reporting will create misleading information ignores the Commission's often stated policy, which it has followed since inception, to refrain as much as possible from prescribing detailed accounting procedures or practices. Instead it has supported and cooperated with the accounting profession in its efforts to develop sound accounting principles.

ITEM - One comment contained the rather startling statement that in the attempt to extend reporting requirements there is danger in too great a preoccupation with the interests of the shareholder. The reasons advanced are that the additional information provided for the benefit of shareholders would be very valuable to competitors, would endanger customer relations, would provide advantages to unions in their collective bargaining negotiations, and also would place an additional financial burden on the company. Since all of these factors would tend to impair a company's profit position, the shareholder would be harmed more than helped.

^{4/} "Corporate Diversification and Financial Reporting" by Leopold Schachner, Journal of Accountancy, April 1967, p. 50.

^{5/} "Economic Concentration," Hearings before the Subcommittee on Antitrust and Monopoly of the Committee of the Judiciary, United States Senate, Eighty-ninth Congress, Part 5, p. 1987.

These arguments seem to be based on an assumption that the additional breakdowns will be more detailed than those we have discussed as possibilities, such as divisional activities, broad product lines, or general market areas. In these limited areas of disclosure it does not appear that such harmful effects would occur, especially when it is considered that competitors, customers and labor unions already have good sources of information on the costs and profits of the companies with which they deal. These protests are similar to those which greeted the implementation of the Securities Acts a generation ago.

ITEM - The comment has been made that any additional reporting requirements developed by the SEC, while ostensibly for the protection of investors, will be primarily for the benefit of the antitrust and trade regulation agencies.

Chairman Cohen has publicly emphasized and defined the SEC's proper area of concern in this matter as being investor protection. He stressed this responsibility in his testimony before the Senate Subcommittee on Antitrust and Monopoly as follows:

"I am not interested officially in the sense of having responsibility for the anticompetitive concerns that have been expressed here. The Commission is interested in fulfilling its responsibility under the statutes to provide information, meaningful information, with respect to companies the securities of which are traded in our securities markets, whether they be small or large." 6/

ITEM - Some comments have been made that very little progress has been made or will be made on a voluntary basis in providing additional disclosures on the diversified operations of companies. One writer cited a survey of the 1966 annual reports of 30 large companies that were considered to be

6/ Ibid., p. 1991. See additional pertinent comments at pp. 1991, 1992, 1995.

conglomerates, which showed that only five companies disclosed profitability by segments and an additional five disclosed sales by product lines. Another writer noted a survey of the 1966 annual reports of 50 companies, selected on a somewhat random basis, which indicated that 25 companies provided some breakdowns of sales but none provided earnings figures on a segmented basis.

Notwithstanding these rather discouraging statistics, we have found in our surveys that progress is being made. A comparative survey of the 1965 and 1966 annual reports of 241 large companies (sales over \$100 million) showed that the number of companies providing a breakdown of sales on a segmented basis increased from 37% to 51% of the total. Oddly, there were some backsliders noted--seven companies had furnished such breakdowns in 1965 but did not in 1966. In an expanded group of 331 companies, we noted 24 which gave substantial disclosures on the profit contributions of their different product lines or divisions which were of three general types:

relative contributions to net income; relative contributions to net income before allocation of corporate overhead, taxes and other items; and the relative "operating profits" (after directly allocated selling and administrative costs) of the various divisions. While this figure is not large it should be kept in mind that very few companies provided such disclosures in 1965 and that many of the companies surveyed were not widely diversified.

In a recent survey of 265 1933 Act filings (prospectuses) by companies with sales in excess of \$25 million, we found that 97% of the companies provided breakdowns of sales by two or more categories and 17% of the companies provided additional breakdowns on net income or relative contributions to net profit. We believe these data may also be indicative of further improvements in subsequent annual reports.

Improvements were cited in the article "New Disclosures Noted in Annual Reports" in the June issue of your Financial Executive on the basis of a survey of 63 companies which showed that "18 introduced new reporting techniques in their current annual reports either by listing percentages of sales by product grouping or by industry market, or by relating profit percentages to products or operating divisions." The article described the techniques used in showing earnings breakdowns in the informative reports of Continental Oil, Evans Products, General Acceptance, Glidden, Greyhound, Gulf Oil, National Distillers & Chemical, Olin Mathieson Chemical, Singer, and Textron.

I believe these statistics indicate an increasing awareness by corporate financial officers and accountants of the necessity of providing additional information, as well as a response to the urgings of Chairman Cohen and leaders of industry and professional organizations that more detailed information be provided on a voluntary basis. Mr. Lanterman of your organization was a pioneer. At any rate we have been encouraged by improvements made to date, both as to the quantity and the quality of reporting. We have noted other examples of noteworthy disclosures by large diversified companies. Bangor Punta Alegre Sugar Corporation presented graphical data for four years showing income before federal taxes for four operating divisions. Kern County Land Company, which incidentally is being taken over by Tenneco, another diversified company, included in tabular form for 1965 and 1966 the contributions to consolidated earnings (before corporate income and expense) of three operating divisions. The Pittston Company disclosed the percentages of gross revenues and net income from three product lines in a comparative graph. Wallace & Tiernan, in a narrative discussion,

stated the operating revenues and net income, as well as the amounts of research and development expense, capital expenditures, and changes in inventories and their balances, for three divisions.

In extending our surveys to the smaller companies (revenues under \$100 million) we have noted that a surprising number of them are also widely diversified. We have also noted the somewhat discouraging fact that very few of them have provided any detailed disclosures on their diversified activities. There are some notable exceptions, however: Natpac, Inc., which had gross revenues of approximately \$10,000,000, provided a breakdown of the revenues and net earnings for three divisional activities; Woods Corporation, with total revenues of slightly more than \$39,000,000, provided within the income statement a breakdown to the gross profit line for three revenue sources; Interstate Engineering Corporation, with total sales of almost \$38,000,000, separated the sales and net income for 1965 and 1966 between defense and nondefense activities in a comparative chart.

These findings remind us that we must take into account the small as well as the large companies in developing rules or guidelines, inasmuch as the SEC's responsibility for investor protection relates to all companies subject to its jurisdiction regardless of size.

The Accounting Principles Board of the American Institute of Certified Public Accountants, in the recently published statement "Disclosure of Supplemental Financial Information by Diversified Companies," has also indicated that there is an increasing trend by diversified companies to disclose additional information. This advisory statement of the APB, in which such companies are urged to consider "disclosing voluntarily supplemental financial information as to industry segments of the business," is

a valuable added influence in the efforts toward improvements in disclosures on a voluntary basis, and it should contribute substantially to further progress.

In response to comments to the effect that companies should be permitted to select their own bases for presenting additional disclosures, it seems appropriate to cite the Chairman's suggestions for voluntary disclosures and the progress I have noted. We believe that the best disclosure will be provided on a voluntary basis. If widely followed, it would appear that any extension of our requirements could be on a minimal basis. Most companies then would be effectively presenting the data on their own bases. In these circumstances it could be said that our rules would affect only the small minority which, as is so often the case, does not cooperate willingly. We will need to consider the extent and quality of the voluntary disclosures in determining what rule-making may be necessary. I might add here, in response to some comments that such rules will be imposed on a rather arbitrary basis, that all proposals would be exposed for public comment before the adoption of definitive rules.

I should like to comment briefly on the progress being made in your study of the conglomerate problem as discussed by Mr. Nagel and Dr. Mautz. The fact that you have been able to establish a definite completion date in the not-too-distant future is in itself encouraging. Our discussions at the advisory board meetings have indicated that much valuable information will be developed on the opinions of industry and the financial world regarding all aspects of this project which will be helpful to us in our consideration of the problem. Of current interest in this connection is the requirement in the Companies Act 1967 in England that directors' reports

for financial years ending on or after the 27th of July, 1968 shall state the turnover and profitability or otherwise attributable to each substantially different class of business.

The articles prepared by Dr. Mautz are valuable additions to financial reporting literature. The definition of a conglomerate that he has provided goes far toward solving the semantics problem related to the classification of companies for this project. We believe that this definition represents a good approach to the development of additional criteria for informative disclosures of the diversified operations of companies. As I indicated in a talk at the NAA convention in June, we agreed that variances in rates of profitability, degrees of risk and opportunities for growth are the principal areas for which additional disclosures are needed.

Finally, I would like to repeat the Chairman's invitation for you to call upon us if we can help in any way in expediting the work on the project and in assuring its successful completion.

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