FINANCIAL REPORTING BY CONGLOMERATES

Address of

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The invitation for Securities and Exchange Commission participation in this conference was tendered before the change in command at the Commission. The course of events resulted in my nomination to accept the assignment.[1/] Regular participants in these meetings, designed to bring members of the accounting profession together to discuss problems of common interest, will recall that David Norr and I appeared on your program four years ago. Our paths have crossed a number of times since then, and I am pleased to see him on your program again. I have refreshed my recollection of his remarks four years ago. He was quite critical of accounting on that occasion. I hope he will concede this time that some progress has been made in four years, but I know he will not be completely satisfied.

On our first meeting here both of us covered considerable territory in discussing financial reporting. This time my assignment is to discuss the financial reporting problems of the "high flyers," as your program committee characterizes the companies commonly referred to as conglomerates. As your program indicates, the topic covers two aspects of the current situation. One part is the accounting for the acquisition of other companies and the distinction between the pooling-of-interests and purchase concepts. The other part of the problem is the question of disclosure of the results of operations of the expanding enterprise. Is an over-all report adequate today or should some reporting by operating segments be required? I shall discuss these two aspects of the problem in reverse order. But before getting under way I should observe that the program this year is in some respects a continuation of last year's. Frank T. Weston then gave you a

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thorough briefing on the activities of the Accounting Principles Board of the American Institute of Certified Public Accountants under the title "Accounting Concepts Under Fire." Mr. Weston called your attention to the fact that the Board at that time was concerned with, among other matters, "business combinations, poolings, purchases, goodwill, etc." and observed that accounting in these areas was being challenged as not making sense today. He also asserted that the Board was maintaining a strong interest in developments in the area of reporting by diversified or conglomerate companies. He also laid down a challenge for David Norr and me in a paragraph which I believe deserves quotation as an introduction to our proceedings today and tomorrow. He said:

> "It is interesting to note, in discussing the usefulness of financial information, that no one group today has effectively championed the interest of the average investor in the way that many of us on the Accounting Principles Board would like to see. In considering some of its problems, it is very difficult for the Board to find someone to talk to on a continuing basis who represents the general public investor, the average investor. We try to deal with analyst groups, but there are many different types of analysts: analysts working for corporate trust and pension funds, analysts with insurance companies and banks, and analysts who work for estates and trusts and for individuals, and analysts with investment banking and stock brokerage firms. Many of these analysts, particularly the sophisticated ones, are not, we feel, representative of the needs of the average investor. The regulatory agencies are presumably set up for that purpose, but their approach is generally more legalistic and their disclosure requirements are often expressed in vague terms."

The rapid increase in recent years in the number of companies of the "conglomerate" type was brought forcibly to public attention by testimony given before the Senate Subcommittee on Anti-trust and Monopoly in 1965. In response to an inquiry from the subcommittee, the Commission submitted a memorandum in which its disclosure requirements were explained and some of the accounting problems involved in refining and extending those

requirements were discussed. It was pointed out that the Commission had for many years required companies whose business consists of the production or distribution of different kinds of products or the rendering of different kinds of services to include in the description of business item in most registration statements filed under the Securities Act of 1933 and Securities Exchange Act of 1934 information regarding 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. It was also pointed out that, under Regulation S-X, issuers are required to effect a breakdown in profit and loss or income statements between gross sales of products and operating revenues from services, if either class exceeds 10% of the aggregate of the two; and, if done, the corresponding cost of goods sold and operating expense figures would likewise be shown separately.

In May 1966 then Chairman Manuel F. Cohen, in an address before the Nineteenth Annual Conference of the Financial Analysts Federation, discussed the need for more informative financial reporting for the conglomerate company which he defined as a large corporation engaging in a number of distinct lines of business under the same corporate roof. Following this discussion the Chairman was invited to testify on this subject before the Anti-trust and Monopoly Subcommittee. In his testimony the Chairman emphasized that the SEC's interest in the problem was to secure adequate disclosure by companies of this type for the benefit of investors rather than any anti-trust aspects of the problem.

During the summer of 1966, at the Chairman's request, the AICPA Committee on Relations with the SEC and Stock Exchanges made a survey of the problem and at the end of September reported to us. At about this

time the Financial Executives Institute proposed to the Commission that the Institute finance a thorough study of reporting for diversified companies. This proposal was endorsed by the Commission, and I was designated as a member of an advisory committee made up of representatives of organizations concerned with the improvement of corporate reporting. David Norr, who is on your program tomorrow, represented the financial analysts. Dr. Robert K. Mautz, Professor of Accountancy at the University of Illinois, was engaged to conduct the study. A summary of the work and recommendations was completed in December 1967 and the complete report was published in June 1968 under the title Financial Reporting By Diversified Companies.

In the meantime others had become interested in the general problem. The Accounting Principles Board, encouraged by the SEC, released a statement in September 1967 urging accountants to support improved disclosure practices. The National Association of Accountants also completed a study on the subject which was published in April 1968 under the title External Reporting For Segments of a Business.

One other contribution in this area deserves mention here. The staff at the Graduate School of Business Administration of Tulane University organized an excellent two-day symposium, which was conducted in November 1967 with the participation of many prominent persons as well as myself. The papers presented were published in April 1968 under the title Public Reporting by Conglomerates--The Issues, the Problems, and Some Possible Solutions.

With all of this material available, much of it stimulated by the Commission's interest in the subject, the Commission and its staff undertook to develop amendments of its rules so as to elicit additional information

from diversified or conglomerate companies which will be meaningful to investors but not unduly burdensome to the companies.

The Commission published a proposal for the amendment of the description of business items in two registration forms under the 1933 Act and the form for initial registration under the 1934 Act in September 1968.[2/] The release announcing the proposal stated that consideration of comparable amendments to other disclosure requirements was deferred pending completion of the study of disclosure under the Securities Exchange Act of 1934 being made by the Commission under Commissioner Wheat's supervision. This embraces annual and interim reports to the Commission, as well as possible amendments of the rules relating to the content of corporate reports to stockholders.

Over 300 comments were received on our proposal. In some of the comments received we were urged not to adopt the amendments at this time in order to permit corporations a reasonable time to provide extended reporting on a voluntary basis. This is exactly what was done by postponing rulemaking in the areas mentioned even though we have been talking about it and urging voluntary disclosure for several years and so have the American Institute of Certified Public Accountants, National Association of Accountants, and the Financial Executives Institute. In any event, the voluntary treatment does not seem to be the way to accomplish the desired results in prospectuses and initial registrations with the Commission.

The proposal called for disclosure on several matters not covered by existing instructions in the description of business items in the forms but which have been disclosed in one way or another in response to common

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2/ Securities Act Release No. 4922 and Securities Exchange Act Release No. 8397, September 4, 1968.

administrative or financial reporting practices. Considerable objection was raised to what appeared to be an extension of the requirements to include foreign operations, government business and single customers. These and other objections and questions were resolved through extensive changes in a revised proposal which was published in February 1969.[3/]

In general the proposal as amended would require separate disclosure of the gross revenue and a defined income of any line of business (a) which contributed 10% or more to total revenues, (b) which contributed 10% to the total income before income taxes and extraordinary items without deduction of loss lines, and (c) which has a loss which equals or exceeds 10% of the income as specified in (b). Separate reporting for more than 10 lines of business is not required. For companies which are not engaged in more than one line of business separate reporting is required for the amount of sales or revenues for each product or service or class of similar or related products or services which contributed 10% or more to the total of sales and revenues. In addition, information is required to be reported regarding (a) the importance and the relationship to the registrant of major customers or groups of customers, (b) the volume of business and risks attendant upon foreign operations, (c) competitive conditions within the industry, and (d) any portion of the business subject to renegotiation of profits or termination of contracts or subcontracts at the election of the government. There is no requirement that this data, which is to be presented under the description of business item in the narrative section of the registration statement, be certified by the independent accountants. There has been some misapprehension on this point.

3/ Securities Act Release No. 4949 and Securities Exchange Act Release No. 8530, February 18, 1969.

In comments on this proposal, as well as on the first proposal, objections have been raised to the 10% test for disclosure of the data on separate lines of business. The following comment is illustrative: "Any requirement should pertain to product lines which make 'substantial' contributions to sales or income, thereby providing some flexibility to issuers, rather than impose a rigid '10 percent or more' standard. If, however, rigidity is, for reasons that escape us, essential, we suggest that the existing 15% standard be continued."

As noted, our present rule uses 15% of volume of business as the test for disclosure regarding the relative importance of products and services or class of products and services. The FEI study suggested retention of this test, but we proposed dropping it to 10% of volume of business or net income before extraordinary items and income taxes. For some time we have felt that the 15% test was too high here and in some other rules. The financial analysts who responded in the FEI study seemed to support our view since the majority indicated that 10% to 14% was the desirable measure and that the maximum number of segments of the business to be reported should be 11 or less. While substantially all of the individual corporations which commented on this point in responses to our two proposals were opposed to the reduction from 15% to 10%, only about one half of the corporations covered this subject in their letters of comment. However, a review of reports to stockholders reveals voluntary disclosure on segments of the business which are less than 10%. We must assume that such disclosure of distinct lines of business reflects management's judgment as to meaningful reporting. In some cases very little disclosure of this nature would be made under a 15% test.

As an example, one company disclosed in its 1968 annual report the revenues and profit contributions for eight lines of business, two of which would not have been required had a disclosure requirement with a 10% test of revenues or income been in effect for annual reports. Under a 15% test disclosure of only four of the lines of business would have been required. The breakdown revealed significant differences in the profit contributions of various segments of the business. At one extreme a segment contributed six percent of the revenues and one percent of the profit and at the other extreme a segment contributed nine percent of the revenues and 30% of the profit.

Many questions were raised regarding our definition in the first proposal of a segment of the business which indicated that we had not communicated clearly what was intended. The rule now in the forms refers to the production or distribution of different kinds of products or the rendering of different kinds of services and, as noted, requires a disclosure of the relative importance of each product or service or class of similar products or services which contributed 15% or more to the volume of business. Our first proposed amendment eliminated the reference to <u>each</u> product or service and instead used a broader term--each class of related or similar products or services. We thought this terminology, when considered with the criteria from the FEI study for their segmentation which we incorporated into the rule, caught the spirit of the recommendations in that study while retaining language familiar to practitioners before the Commission. In the discussion in the release of the proposed changes we referred to registrants engaged in different lines of business. The FEI study speaks of broad industry groupings, and the sponsors felt that we had disregarded their suggestion in this respect.

In the second exposure we restated the requirements for disclosure on separate segments of the business in terms of "lines of business" in lieu of "each class of related or similar products or services" to meet this criticism. We have retained the criteria of the FEI study--rates of profitability of operations, degrees of risk and opportunity of growth--as guides in the segmentation process. While there have been some additional comments that a more precise definition of the term "line of business" should be provided, we believe that this would limit unduly management's prerogative to exercise its judgment in this matter.

Comments were received on the second proposal to the effect that we had introduced a new requirement by specifying that, in addition to reports on lines of business, the amounts of sales or revenues contributed by "each product or service or class of similar or related products or services" which are 10% or more of the total of sales and revenues should be reported in certain instances. One commentator stated:

> "Paragraph C introduces a new reporting requirement. This would call for product reporting even in a unitary company. We fail to see how this could have any significance for our investor. We do not understand why this is now proposed when it did not appear in the original release last September."

We consider this requirement to be closely comparable to the requirement that has long been in effect in the description of business item in the forms (except for the change from 15% to 10%) which produces information essential to a description of the business. And, as previously noted, we are already getting a partial breakdown along these lines at the 10% level in the income statement. We effected changes in the last revision of the amendments to clarify this point and to provide for the combining of the data if it would otherwise be duplicated in the two areas of reporting.

The redraft is now before the Commission for consideration.

While these rules deal with one aspect of reporting for diversified or conglomerate companies, the rapid growth of corporations through the acquisition route, particularly by the exchange of securities, has created or accentuated other important accounting and reporting problems. The history of the concept of a pooling of interests and the bases for distinguishing a pooling from a purchase have been recited many times. The relative merits have been debated vigorously for about the last twenty years.

Recurring problems arise today in determining whether pooling or purchase accounting is appropriate in a business combination. We have dealt with the questions on a case-by-case basis, using as a reference the criteria set forth in ARB No. 48, "Business Combinations," which was issued in 1957. The serious judgmental area is the provision that no one factor is controlling, which means that if some factor lends strong support for a pooling solution weaknesses in others may be disregarded. Each case where pooling accounting is desired is argued as being substantially the same as other identifiable cases which are deemed to be precedents--any difference is claimed to be immaterial. As a result, the staff of the Commission and representatives of registrants and their accountants have had to reach a workable interpretation of the criteria in each case, but this has led to serious erosion over the years.

My experience in writing about this problem is that a statement of current policy seems to be obsolete before the paper gets into print. We agree with those who believe that the situation has now reached a point

where, because of the serious erosion of the standards, as well as the introduction of new types of securities, the changing climate for mergers, and other economic factors, a serious reexamination of the prevailing practices in this area of accounting must be made.

It was stated in a recent Fortune article[4/] that "aggressive conglomerates have found the pooling-of-interests arrangement very much to their tastes." The article cites some of the advantages--the tax-free aspects to the selling stockholder, the boosting of earnings in the year of the deal by adding the earnings of the two companies together, the omission of any goodwill in the transactions--and goes on to state that "the value of the merged company's assets is understated and immediate earnings per share are overstated." If a convertible preferred stock is issued in the deal there may also be a question as to whether the earnings per share data are further overstated.

The APB of the AICPA has been considering these problems for some time and has assigned a high priority to the development of solutions. Last October the long-awaited Accounting Research Study No. 10 was released by the Institute. "Accounting for Goodwill" by George R. Catlett and Norman O. Olson is commanding considerable attention. This work was authorized to serve as a necessary companion to ARS No. 5, "A Critical Study of Accounting for Business Combinations," by Arthur R. Wyatt.

Messrs. Catlett and Olson have reached the conclusion in their study that the accountants have failed to hold the line and they have endorsed Wyatt's conclusions that, except for rare cases in which they consider a

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4/ "The Merger Movement Rides High," Fortune, February 1969.

new enterprise has been created, the proper accounting for business combinations is found in the general concepts underlying purchase accounting and that pooling-of-interests accounting is not a valid method. This conclusion leads them to the problem of accounting for goodwill which may arise in a purchase transaction and they conclude that the goodwill should not be set up as an asset and amortized by charges to income but should be accounted for as a reduction in stockholders' equity at the time of the combination.

I have observed that there is considerable misunderstanding in financial and legal circles as to the present requirements for accounting for goodwill. It is often stated that purchase accounting is not desirable when there is an excess of the purchase price over the underlying equity acquired, as this debit excess must be amortized. While there is respectable support for amortization, the applicable rules 5/ in effect today do not require amortization of this intangible unless it is deemed to have a limited life. Most managements represent just the contrary--no plan of amortization has been adopted because no diminution of value of the intangible is foreseen. Occasionally we find a situation in which the value attributed to the stock issued in exchange is less than the underlying equity acquired as shown on the acquired company's books. In this situation we have objected to purchase accounting when the criteria for the pooling treatment are present to avoid the creation of a credit excess which under current rules 6/ must be amortized. There is an inconsistency in the

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5/ Chapter 5, Accounting Research Bulletin No. 43, and Accounting Series Release No. 50.

6/ Accounting Research Bulletin No. 51.

Institute's Accounting Research Bulletins under which amortization of a debit excess is optional but amortization of a credit excess is required. This needs correction.

It is significant that all members of the Project Advisory Committee for the goodwill study commented on it. One member, a partner of the authors of the two studies, recommends that the Board issue an opinion as soon as possible adopting the conclusions of the study. Another member believes the AICPA should not attempt to solve this problem alone but should organize an advisory council such as was formed by the FEI to assist on its study, Financial Reporting by Diversified Companies. (Publication of the study, of course, is intended to elicit comment from all interested parties.) The other five members of the advisory committee agreed in part and disagreed in part, some in sharply worded comments.

Some members of the committee suggest that there is a place for the pooling-of-interests concept but the criteria need reexamination. Others disagree on the recommended accounting for goodwill under the purchase approach. Some believe that immediate write-off of goodwill is inconsistent with the purchase concept and that amortization should be required. It is obvious that the subject must have our serious attention.

We are not convinced that all pooling accounting should be prohibited or that goodwill in purchases should be written off immediately. Are there not many true combinations which are better portrayed on a pooling basis? In those acquisitions properly classified as purchases, would not the shareholders be better informed if the goodwill is reported to show the full cost, and would not the income be more fairly stated if it is charged with amortization of that goodwill over a reasonable period?

The use of hybrid equity securities in poolings--the gimmicky convertibles, the warrants, etc.--raises not only the question of whether they are intended to artificially increase earnings per share but also another question. Do these securities violate the most basic criterion of the pooling concept, that the common stock interests of the several owners should remain substantially proportionate to their interests in the predecessor companies? This is one of the areas where there have been many compromises over the years that have resulted in the erosion of the standards.

In accordance with the Commission's long-standing policy of cooperation with the accounting profession in the development and improvement of accounting standards, it is our practice to comment on the accounting research studies sponsored by the APB, as well as on the opinions of the APB which may or may not follow the conclusions of related studies. Copies of the goodwill study were made available to all of the Commissioners and to accountants on the staff. In our letter of comment to the Institute we made a number of suggestions for criteria pertaining to both the theoretical aspects of purchase or pooling accounting and the practical problems involved.

Some of our suggestions for acceptable criteria for pooling-of-interets accounting were:

The acquiring company should issue only unissued common shares or convertible preferred stock which is a common stock equivalent at issuance and has voting rights equal to those of the common stock into which it is convertible in exchange for the common shares or net assets of the company being acquired. Other types of securities, such as convertible debit and warrants, should not be used in a pooling transaction.

The combination should be between viable corporate businesses and there should be a plan for continued operation of the businesses. The combination should be a tax-free reorganization.

As a practical matter, there should be a substantial size test with a minimum disparity of two to one between the combining enterprises.

Under these criteria, fractional shares and immaterial amounts of dissenters' shares could be settled in cash and immaterial minority interests could survive in a pooling transaction, but part-purchase part-pooling accounting would not be acceptable. Companies which are acquired primarily to obtain disposable undervalued assets, such as real estate holdings or natural resources, or companies with loss records should not be pooled. Also, dissimilar companies such as banks, insurance, and savings and loan companies should not be pooled with industrial companies. The holding period for shares received by selling stockholders should be governed only by legal considerations and not as a condition for pooling treatment.

In regard to purchase accounting our suggestions were, in general, that purchased goodwill should be recorded and amortized to income over a reasonable period of time with 30 to 33 years being the upper time limit with a shorter period being required where the circumstances warrant, and that paragraph 8 of ARB No. 48 be reexamined to provide a more realistic basis for the valuation of the purchase transaction when securities are issued in the exchange.

At the present time most business combinations are brought within the pooling concept. Reporting for the continuing enterprise then becomes a problem. The concept of a pooling is that formerly separate businesses combine and continue to operate as though they had always been one enterprise.

It follows that after a pooling the prior years' results must be combined for a proper comparison with the current and subsequent years. This procedure is required under APB Opinion No. 10.

The Commission supported this method of reporting in Securities Act Release No. 4910. The Commission observed in this release that "where a 'pooling of interests' has occurred, companies may wish to reconcile 'restated' sales and net income figures with those previously reported. This may be done by presenting, in addition to restated income statements, separate statements of income for the same periods on a historical basis, i.e., 'as previously stated,' or by breaking down the sales and net income figures in the restated income statement for each period to show the amounts attributable in that period to the pooled companies." This latter device is being requested in summaries of earnings in material filed with the Commission. This device distinguishes internal growth from that contributed by pooled acquisitions.

You may recall that this release was occasioned by a company which, while presenting its certified financial statements properly on a pooled basis in accordance with the APB opinion, had made improper comparisons between the pooled and unpooled income data in the "up-front" material in the annual report and in paid advertisements. Such misleading comparisons tend to raise a question as to whether the companies are more interested in showing growth by acquisition than by application of managerial talents.

Release No. 4910 also dealt with one phase of another problem that has become increasingly serious, in large part because of the merger movement and the use of complex and hybrid securities to effectuate the combinations. This is the question of the appropriate bases for the computation and

comparison of earnings per share data. The guideline laid down in this release pertained to "Convertible preferred stock as a residual security upon issuance in acquisitions in the determination of pro forma earnings per share." The problem here was dilution of earnings. The Commission stated, in part: "In general, if at the time of issuance of a convertible security in an acquisition, the terms are such as to result in immediate material dilution to pro forma earnings per share, assuming conversion, then that security should be considered a residual security whether or not a majority of its value may be derived from its conversion rights."

The need for this rule arose because of certain deficiencies in APB Opinion No. 9 pertaining to earnings per share. Soon after this opinion was issued in December 1966 it became apparent that it needed expansion and clarification and also simplification. I hope the opinion will provide workable criteria for all the problem areas.

The increasing number of business acquisitions has also intensified a problem related to the requirements for certified financial statements of the acquired company in registration statements filed with the SEC by the acquired company. In general such certified statements are required for a three-year period, the same as for the registrant. The Commission can grant relief from this requirement if such relief is consistent with the protection of investors. The staff considers the materiality of the acquired company in relation to the acquiring company in making a decision in each case. However, there were no formal guidelines for making decisions regarding the materiality factor. This has caused difficulties for registrants in requesting relief and for the staff in processing the requests. The situation has become worse as the number of requests for relief has increased.

In order to alleviate this problem the Commission issued guidelines 7/ in February that can be used by registrants to determine whether a request for relief would be appropriate and the extent of the relief that may be granted. Materiality tests of certain relationships between the registrant and the acquired company are provided which give an indication as to whether full relief, partial relief, or no relief may be granted.

As this paper was being finished, the special study of disclosure under the 1934 Act in conjunction with the 1933 Act, which I mentioned previously, was completed and published for comment, 8/ and the report has been submitted to the full Commission for consideration. It contains a number of recommendations for better disclosure which, if adopted, will affect the accountant's work in filings with the SEC.

Some of these recommendations relate to the topic under discussion here. More business combinations would be made subject to registration with the SEC under one recommendation for the adoption of a special registration procedure. The proposal would require registration of securities issued in mergers and the acquisition of assets which at present are exempt from registration, in contrast to consolidations effected through an exchange of stock which are subject to registration.

The report recommended that the annual 10-K report filed with the SEC be amended to require considerably more detail about the operations of the business including an indication of how much sales and income are contributed by separate lines of business. The 10-K report would also be made more

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7/ Securities Act Release No. 4950, February 20, 1969.

8/ See Securities Act Release No. 4963 and Securities Exchange Act Release No. 8568.

timely by the recommendation that it be filed within 90 days after the end of the fiscal period (instead of 120 days at present) or within five days after the report to shareholders is published if this is earlier. In regard to the report to shareholders a rule was recommended to prevent the presentation of textual references to, or condensed tabulations of, material in the certified financial statements in a misleading manner by indicating a financial position or results of operations significantly more or less favorable than that revealed in the full statements.

Another recommendation was for a new form to be substituted for the present Forms 8-K and 9-K, which would be required to be filed within 45 days after the close of each fiscal quarter. Condensed, comparative financial data would be required in the reports for each of the first three quarterly periods. Significant acquisitions or dispositions of assets would still have to be reported, and on a more current basis.

Many other recommendations were made for improved disclosures in reporting forms, as well as other areas. The proposals for revision of the reporting forms are based on the following principles:

(1) Reports should be timely but not unduly burdensome.

(2) Reports and registration statements should provide information of maximum utility to investors and their advisers.

(3) Requirements for a new filing of material already disclosed in an earlier one should be avoided.

(4) The format of reports and registration statements should be compatible with microfiche reproduction (which the SEC is already utilizing by a contract with a commercial organization) and other contemporary data processing techniques.

In this connection I might note that just recently the SEC published for comment a proposal 9/ to require a registration statement summary sheet which would facilitate the automated processing of data through our computer, the dissemination of information to our regional offices for public information purposes, and also our own recordkeeping.

While I have discussed a number of accounting problems arising out of the merger movement and the conglomerate trend, I do not wish to give the impression that all of the problems of this phenomenon involve accounting solution.

As you know, questions have been raised by committees of the Congress, and others, regarding the extensive use of convertible debentures in acquisition programs and the equity of the tax benefits accorded the interest costs in such situations. Others are looking at the anti-trust aspects with a view to determining whether restrictions should be applied.

The merger movement has indeed raised many questions and created many problems, which all of us need to consider.

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9/ Securities Act Release No. 4960 and Securities Exchange Act Release No. 5650, April 10, 1969.