THE SEC'S ROLE IN CHANGING PATTERNS

IN FINANCIAL REPORTING

Address of

ANDREW BARR
Chief Accountant

Securities and Exchange Commission
Washington, D. C.

Before the

Hankamer School of Business
Alumni Conference

on

"The Age of the Conglomerate"

Baylor University
Waco, Texas

April 24, 1970

The theme of this conference--"The Age of the Conglomerate"--is one in which the business executive, the practicing accountant, and the government official certainly have a joint interest, and hopefully a common interest, in the organization and the financial reporting of the business enterprise which is commonly referred to as a "conglomerate."[1/] The term "conglomerate," to most observers of the financial scene, seems to mean a business enterprise which has grown by the device of acquiring other companies in different lines of business by purchase for cash or debt securities or through the exchange of securities of various kinds; for example, common stock, convertible preferred stock, or convertible debentures. The exchange may be a simple common stock for common stock transaction or any combination of securities which the investment bankers and their clients think will accomplish the mission of effecting the transaction to the mutual satisfaction of all the parties involved. While the combining of companies in this manner for expansion purposes rather than relying upon internal growth is not new, the emphasis on combining companies with disparate products and services is a fairly recent development. Much of the public criticism of financial reporting today stems from this expansion activity and it centers on the alternate means of consummating the transactions and the propriety of the accounting adopted to reflect them.

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.

The term "conglomerate" may also be applied to the company which has developed new lines of business by internal means. Regardless of the means employed, the financial reporting for this type of enterprise has attracted considerable attention during the last five years. Financial analysts and economists have raised serious questions as to the adequacy of financial reporting when all of the activities of a diversified business are reported only through consolidated financial statements. An agency such as ours, which is charged under the securities acts with responsibility for requiring disclosure of financial information for investors, has a vital interest in these developments I have sketched by way of introduction to a discussion of the SEC's role in the changing patterns in financial reporting.

As I have intimated, the principal financial reporting problems in the age of the conglomerate seem to be concentrated in the accounting for the acquisition transactions and thereafter in the reporting on the results obtained. The first aspect of the matter has two practically inseparable and highly controversial parts. First, is the pooling-of-interests concept, whereby the combined entities are merely added together without restatement of accounts on either side, valid? Second, when purchase accounting is deemed appropriate under existing standards and the price paid is more or less than the underlying equity acquired, what is the proper accounting for any difference remaining after allocation of the purchase price to the assets acquired and any necessary adjustment of liabilities? Is goodwill an asset that will last forever or should its ultimate demise be recognized in advance by amortization through charges to income? The SEC has been involved for many years in the consideration of these questions.

With the growth of the conglomerate the SEC has become more clearly identified as a party interested in line of business reporting. As will be shown, certain of our reporting requirements have dealt with this matter over a considerable period.

Before going any further, I should like to point out that Commission policy for practically its entire life has been to support the accounting profession in its efforts to identify, state, and improve the definition of accounting principles governing the preparation of financial statements. Commission Chairmen, other Commissioners, and key staff members have described this policy on many occasions, including appearances before congressional committees. This spirit of cooperation has not always been completely harmonious on every point at issue, but differences of opinion to the degree that the Commission has had to express views contrary to those expressed by properly constituted representatives of the profession have been rare indeed.

Accounting for Goodwill

The present debate over goodwill is an example of an accounting matter over which differences have existed for many years. The profession first dealt with this matter formally in December 1944 when the Committee on Accounting Procedure of the American Institute of Accountants (now American Institute of Certified Public Accountants) issued Accounting Research Bulletin No. 24 on "Accounting for Intangible Assets." This bulletin classified intangibles between (a) those with a limited life and (b) those having no such limited term of existence, such as goodwill generally. The committee recognized that ". . . in the past it has been accepted practice to eliminate type (b) intangibles by writing them off against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus."

The committee endorsed carrying goodwill at cost until it becomes reasonably evident that there is a loss of value and supported discretionary amortization at any time as a managerial decision but did not endorse mandatory amortization. Attention was drawn in the bulletin to a rule adopted by the membership of the Institute in 1934 which provides that "capital surplus, however created, should not be used to relieve the income account of the current or future years of charges that would otherwise fall to be made thereagainst."

The Commission had trouble accepting this opinion as it seemed to leave a loophole for immediate write-off of purchased goodwill when no loss of value could be anticipated. In Accounting Series Release

No. 50, issued in January 1945, the Commission, through its Chief Accountant, took issue with a registrant's proposal to write off purchased goodwill by a charge to capital surplus. The then Chief Accountant's opinion, which is still policy, was that ". . . the proposed charge to capital surplus is contrary to sound accounting principles. It is clear that if the goodwill here involved is, or were to become, worthless, it would be necessary to write it off. Preferably such write-off should have been accomplished through timely charges to income, but in no event would it be permissible, under sound accounting principles, to charge the loss to capital surplus. The procedure being proposed would, however, evade such charges to income or earned surplus and would consequently result in an overstatement of income and earned surplus and an understatement of capital."

In a revision in 1953, the Institute's bulletin was brought into agreement with the SEC's position, as can be seen in the following paragraph:

> "9. Lump-sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles." 2/

2/ Accounting Research and Terminology Bulletins, Final Edition, 1961, American Institute of Certified Public Accountants, Chapter 5, page 40, first published in 1953 as Accounting Research Bulletin No. 43.

In the present consideration of the subject the Commission has endorsed a proposed opinion of the Accounting Principles Board of the AICPA which would require amortization of all intangibles by timely charges to income on a reasonable basis but not in excess of 40 years. The solution to this problem cannot be separated from the pooling-purchase matter. One critic of accounting for goodwill said recently that "'Pooling of interests' came into being after World War II, when SEC Accounting Series Release 50 prohibited a direct write-off of goodwill to capital surplus. At this point cool, clear reasoning was abandoned and corporate management and the accounting profession embarked on a disastrous program of patchwork and rationalization. Accounting Series Release 50, which could not have stood on its own merits, was not even challenged but was circumvented by devising the 'pooling' concept. Its purpose was to avoid recording goodwill on the balance sheet and to carry forward the surplus balances of the constituent entities. Because postwar inflation was only just beginning to affect the economy at that time, the difference between pooling and purchase accounting was not great, and this seemed an easy solution." 3/

A contrary view of goodwill was stated by a business executive at about the same time. He deplored the pooling of interests concept, supported purchase accounting for practically all business combinations and advocated amortization of any goodwill in not over 10 years. 4/

3/ J. Kenneth Hickman, New Jersey CPA, Fall 1969, pages 24-25.

4/ John V. VanPelt, III, The New York Certified Public Accountant, January 1970, page 57.

Several years ago I summed up the status of the goodwill controversy in one paragraph following a discussion of accounting for business combinations:

> "As this brief discussion of pooling of interests indicates, uniform accounting treatment of goodwill has been a difficult problem for many years. Current authoritative pronouncements on the subject prohibit the write-off of goodwill to earned surplus immediately after acquisition, or to capital surplus. _/ Present accounting for poolings is considered by some accountants to be an evasion of these rules. Most businessmen, bankers in particular, seem to be allergic to goodwill as a sound balance sheet item. It is clear, however, that there is something seriously inconsistent in paying substantial sums for goodwill and then, by the immediate write-off, representing that it has no value. The classic comment on the subject was made by Charles B. Couchman forty years ago, 'To put it briefly, if you can write it down, you need not; if you cannot, you should! It is self-evident that only in a profitable business can the element of goodwill be rightfully claimed to exist. _/'" 5/

Accounting for Business Combinations

Since our Accounting Series Release No. 50 has been cited as precipitating the rapid adoption, and thereby the forerunner of later erosion, of the pooling of interests method of accounting for business combinations, some review of the Commission's involvement is in order. I did this in 1958 in a paper which was later published in The Accounting Review. 6/ Five years later Arthur Wyatt's "A Critical Study of Accounting for Business Combinations" was published. 7/ Both of us placed the beginning of the use of the term "pooling-of-interests"

5/ NAA Bulletin, September 1963, pages 10-11; footnotes omitted.

6/ April 1959, page 175.

7/ Accounting Research Study No. 5, American Institute of Certified Public Accountants, 1963.

at about 1945 but we noted that the basic idea described by this term was recognized as early as the 1920's. The two principal characteristics are that retained earnings of constituents to a "pooling" may be retained as earnings of the resulting entity and the book values of the assets of the constituents may be carried forward to the resulting entity. This idea was expressed in 1928 by Wildman and Powell in their "Capital Stock Without Par Value." These authors were quoted in the second edition of the Accountants' Handbook in 1932.[8/]

Prior to 1945 pooling treatment was appropriate if the parties to the combination were of about equal size and were engaged in similar or complementary lines of business. In that year, however, the Commission considered a case in which it was recognized that all factors other than size supported the pooling treatment and accepted this solution.[9/]

Accounting Research Bulletin No. 40[10/] on "Business Combinations," which was published in 1950, became the guide for the profession and was cited in the Commission's work as authoritative support for pooling accounting. At this time it was generally understood that the bulletin required dissolution of the merged corporation into a surviving corporation. This presented serious legal problems

8/ Page 950.

9/ See William M. Black, "Certain Phases of Merger Accounting," The Journal of Accountancy, March 1947, page 214.

10/ Republished as Chapter 7(C) in Accounting Research Bulletin No. 43.

relating to franchises, leases, licenses, contracts, pension plans and taxes which would be avoided if acquired companies could be preserved alive as subsidiaries. This option was provided for in Accounting Research Bulletin No. 48, which superseded No. 40 in January 1957. The new bulletin also established a size test for the larger partner of 90% to 95% of the combination--a test soon eroded. Bulletin No. 48, with certain changes, is in effect today.

We are involved in a joint effort with the Accounting Principles Board to adopt more restrictive guidelines to govern pooling of interests accounting. The staff, and the Commission as well, has been kept informed of the preliminary study and development work which led to the presently outstanding Proposed APB Opinion: "Business Combinations and Intangible Assets" which was published for comment in February 1970. Prior to its release the Commission had indicated to the APB that it supported the proposed opinion. Chairman Budge on February 18, 1970, in testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, described some of the important criteria which were to be included and filed a copy of the exposure draft when it became available as an exhibit for the record. The criteria that he noted were

(a) Common stock only to be exchanged on a proportionate basis.

(b) The relative size of the combining companies should be at least on a three-to-one ratio.

(c) There must be no intention of liquidating a major portion of the assets of the combining companies, or of retiring or reacquiring all or a part of the common stock issued in the transaction.

(d) There could be no provisions for the contingent issuance of additional securities or other consideration or for any other financial arrangement for the benefit of the former stockholders of a combining company after the consummation.

(e) Pooling accounting could not be retroactively applied to a given fiscal year or the prior years for a transaction which was consummated after the end of that fiscal year.

We were aware of wide differences of opinion on this proposal. The principal ones have been forcefully presented to the business world in releases of the Financial Executives Institute. This organization at first supported a 9 to 1 size test instead of the 3 to 1 test in the proposal but later reconsidered and it now takes the position that no size test should be imposed. The FEI also opposes mandatory amortization of intangibles. These views and those of other interested parties must be considered. All concerned, I am sure, believe this to be one of the most important accounting problems today demanding a prompt solution.

Reporting on Lines of Business

Requirements to disclose the significance of lines of business comprising the total enterprise is not new in SEC regulation, nor is this type of disclosure new in corporate reports to shareholders.

Item (8) of Schedule A of the Securities Act of 1933 calls for a description of the general character of the business actually transacted or to be transacted by the issuer. This item was incorporated in registration forms in 1937--by instructions to state at one point the character of business done and intended to be done and at another to state the general type of business done, such as steel manufacturing. Ten years later Form S-1, adopted January 15, 1947, included an item captioned "Description of Business." Instructions from that item pertinent to the present discussion are the following:

> ". . . If the business consists of materially important lines which are distinct, indicate, insofar as practicable, the relative importance of each such line to the business of the total enterprise in terms of contribution to the gross volume of business done."
>
> ". . . a statement shall be made as to any . . . materially important lines which have been added or dropped; . . .
>
> "Indicate briefly, to the extent material, the general competitive conditions in the industry in which the registrant and its subsidiaries are engaged or intend to engage, and the position of the enterprise in the industry. If several products are manufactured or sold, separate consideration should be given to the principal products or classes of products."

These disclosures were required to be given in the registration statement for the past five years of the registrant. These requirements remained substantially the same until 1951 when a specific size test was introduced into the first instruction which was restated as follows:

> "Briefly describe the business done and intended to be done by the registrant and its subsidiaries and the general development of such business during the past five years. 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."

This version remained unchanged until the adoption of amendments to registration Forms S-1, S-7 and 10 in July 1969.[11/] A comparable amendment has been proposed for Form 10-K to make the requirements in this annual reporting form under the 1934 Act consistent with the registration forms.

As amended the description of business item in these registration forms requires separate disclosure of the gross revenue and a defined income or loss of any line of business which contributed 10 percent or more to total revenues; 10 percent to the total income before income taxes and extraordinary items without deduction of loss lines; or which had a loss which equaled or exceeded 10 percent of such income. Where it is not practicable to state the contribution to this level of income for any line of business the contribution to the results of operations most closely approaching such income must be disclosed. Separate reporting may be limited to the 10 most important lines of business. Separate reporting is also required for each class of similar products or services which contributed 10 percent or more to the total revenues. However, if a company's revenues are not in excess of $50 million, all of the tests are 15 instead of 10 percent. 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 related to foreign operations and the attendant risks, (c) competitive conditions within the industry, and (d) any

---

11/ Securities Act of 1933 Release No. 4988, July 14, 1969.

portion of the business subject to renegotiation of profits on termination of contracts or subcontracts at the election of the government.

Although we were urged to provide a precise definition of the term "line of business," we believed that this would limit unduly management's prerogative to exercise its judgment in this matter. Our reasoning on this point was given in the adopting release as follows:

> "Various suggestions were made for more specific indications of the meaning of 'line of business.' However, in view of the numerous ways in which companies are organized to do business, the variety of products and services, the history of predecessor and acquired companies, and the diversity of operating characteristics, such as markets, raw materials, manufacturing processes and competitive conditions, it is not deemed feasible or desirable to be more specific in defining a line of business. Management, because of its familiarity with company structure, is in the most informed position to separate the company into components on a reasonable basis for reporting purposes. Accordingly, discretion is left to the management to devise a reporting pattern appropriate to the particular company's operations and responsive to its organizational concepts.
>
> "The amendments continue the existing disclosure requirements on breakdown of total volume of sales and revenues by principal classes of similar products or services, except that the percentage test has been reduced from 15 percent to 10 percent in the case of companies having total sales and revenues in excess of $50 million during either of their last two fiscal years. This continued requirement is appropriate in view of the relative freedom given management in determining 'line of business.' Of course, for a company using classes of similar products or services as its basis for determining lines of business, repetition of the disclosure will be unnecessary. It should also be noted that to the extent such classification is not coincident with the company's determination of its lines of business or where the company is not engaged in more than one line of business, disclosure is limited to proportion of sales and revenues and does not require a showing of contribution to earnings."

Some analysts have criticized the instructions for permitting the reporting to be made in dollar amounts or in percentages. The rule reflected practices observed in reports to stockholders. In some prospectuses we have received since the rule has been in effect I have noted some quite revealing responses. In other cases strict application of the instruction, including the size test, has resulted in less disclosure than in reports to stockholders covering the same period. An early example is a prospectus dated in September 1969 in which sales and earnings for principal product lines are reported only in percentages for the most recent three years as permitted by the instructions, while in the 1969 report to stockholders sales by major product groups for five years and the related earnings for the latest three years are reported in both dollars and percentages. An accompanying note in the annual report warns the reader that while the profits reported indicate the relative contribution of the company's diversified operations to total earnings, they are not necessarily comparable to similar data for other companies since accounting procedures may vary. A footnote to the data in the prospectus states that the "figures represent the Company's best estimate of such information in response to a requirement of the Securities and Exchange Commission." It should be emphasized that this information is given in the description of the business item in the narrative part of the prospectus and not as an integral part of the financial statements covered by the opinion of the independent accountant.

Another example of a response to the new requirement may be helpful. A prospectus dated in March 1970 reported under a general heading "Contributions of Major Businesses" the dollar amounts of "Operating and Non-operating Revenues" and the related "Income before interest, federal income taxes, outside stockholders' interest and extraordinary items" with an elimination item for intergroup sales for three years for ten subdivisions of the business. These revenues can be reconciled in total to the certified statement of consolidated income. The headnote to this data includes a sentence commenting on the allocation problem--"While the significance of the results shown in the table is materially affected by stating income before interest and federal income taxes, in the opinion of the Company it is impracticable to allocate such interest expense or taxes in a manner which will fairly reflect the contributions of such major businesses to its net income." The management of this conglomerate prepares an elaborate statistical supplement to its report to stockholders, and it took a keen interest in the development of the SEC rules.

Needless to say, the new disclosure requirements did not meet with wholehearted approval in corporate executive circles. A recent issue of a business journal carried a brief biography of a man who buys companies which included the observation that "As president of a company, whose affairs like those of most publicly-owned corporations, are inextricably bound up with Government policies, Mr. _______ closely watches developments in Washington. He thinks the recent regulations regarding line of business reporting are 'nonsensical" but recognizes the corporate obligation to keep stockholders and investors informed."[12/] This is exactly what the Securities Acts require.

While the development of these new rules has claimed our attention for the past three years, some longstanding rules should not be overlooked. Regulation S-X, which prescribes the form and content of most financial statements to be filed with the Commission, in Rule 5-03 calls for the separate reporting of revenues from services and sales of products if the lesser amount is more than 10% percent of the two combined. If the revenues are reported separately, the rule requires a comparable separation of cost of goods sold and cost of services. A good example of this type of breakdown can be found in the reports of equipment manufacturers where their revenues are derived from sales of products and rental income.

Article 4 of Regulation S-X governs the preparation of consolidated and combined statements. Rules under this article now specify that banks and insurance companies may not be consolidated or combined except under very restricted circumstances and that, in any event, separate or consolidating statements must be furnished which will provide disclosure on these businesses.

The American Institute's rules on consolidation also specify that full consolidation of all subsidiaries is not always appropriate. Accounting Research Bulletin No. 51 states that it may be preferable to present separate statements for a captive finance company where

---

12/ *Management Accounting*, December 1969, p. 57.

the parent is engaged in manufacturing operations. Although some people think that it ought to be merged or consolidated with the parent, it is a more common practice to account for the finance company on the equity, or one-line, basis of consolidation in the parent statement and to provide separate disclosure on that element of the over-all enterprise.

Although I have stressed the need for lines of business reporting, this should not be construed as suggesting that consolidated financial statements are not necessary. Such statements are the most effective way to report the over-all financial position and results of operation of the economic entity. The Commission has emphasized this on a number of occasions. However, with the rapid growth of diversified businesses some indication of their composition is clearly needed to keep the investor informed. This is the SEC's mission in this venture.

--oOo--