CORPORATE FINANCIAL REPORTING: THE DEVELOPING DEBATE ON "LINE OF BUSINESS" DISCLOSURE

x x x

ESTABLISHING CRITERIA FOR LINE OF BUSINESS REPORTING

by

ANDREW BARR
Chief Accountant
Securities and Exchange Commission

Annual Conference

National Association of Accountants

Denver Hilton Hotel

June 27, 1967

The reporting of a certain amount of information by separate lines of business has been required by the SEC for many years. Since 1951 the principal Securities Act registration form has contained a requirement for disclosure of the relative importance of each product or service or class of similar products or services which contributed 15% or more of the total gross volume of business. Similar requirements are included in the form for registration under the Securities Exchange Act and reports are required with respect to material acquisitions and changes in the character of the business. Our accounting regulation applicable under both acts also requires the separate reporting of gross sales and operating revenues if either of them exceeds 10% of their combined total. 1/

Rules governing consolidated financial statements provide in general that principles of inclusion or exclusion shall be followed which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries. Under our rules, financial statements of insurance companies and bank holding companies may not be filed on a consolidated basis except under very restricted conditions, and then only if financial data for the subsidiary companies are provided. Consolidated statements for a company in the development stage are usually not appropriate. If any significant majority-owned subsidiaries are omitted from consolidation, separate or group financial statements for these and significant 50% owned companies must be filed. The financial statements of finance subsidiaries are often omitted from consolidation with its commercial or industrial

---

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.

parent and presented separately. This results in a separation of finance operations from the rest of the business--a practice on which there is some difference of opinion. We share the belief that the equity method of reporting earnings of unconsolidated domestic subsidiaries, recently made mandatory under APB Opinion No. 10 of the American Institute of Certified Public Accountants, results in more informative reporting of the full operations of the business, thus avoiding a combination of dissimilar operations.

The additional disclosure of diversified activities brought about by applying these consolidation practices can be seen in the annual report of just one company. The 1966 report of Greatamerica Corporation contains separate financial statements for its unconsolidated subsidiaries or affiliates--an airline, a bank, a fire and casualty insurance company and two life insurance companies. In addition, the equities in the earnings of each of these companies are reported separately in the parent company statements, thus providing at the same time the results of operations of the total enterprise. This is not an isolated example by any means.

The rapid growth of the merger movement in recent years, particularly the trend toward diversified acquisitions, has focused attention on the need for this type of information and, in general, for more detailed reporting on the operations of the diversified companies.

In 1965 Senator Philip A. Hart, chairman of a subcommittee conducting hearings[2/] on the concentration of economic power, invited Chairman Cohen

---

2/ Published under the title Economic Concentration, Hearings before the Subcommittee on Antitrust and Monopoly of the Committee of the Judiciary, United States Senate, Eighty-ninth Congress.

to comment on a recommendation made by a witness in the hearings that the Securities Exchange Act be amended to require that diversified corporations disclose on a fuller basis than they do now their sales and operating income from different activities in which they may be engaged.

In his reply 3/ the Chairman stated that in his opinion the Commission presently has the authority to require more detailed disclosures of this nature, and discussed several matters to be considered in extending our requirements as summarized below:

1. The value of such information compared with the cost of obtaining such information.
2. The reliability and meaningfulness of such information in view of the problems of joint-cost allocation.
3. The disclosure of information useful to competitors.
4. The problems of rulemaking to elicit useful information.
5. The liabilities imposed by the securities acts.
6. The tendency of corporations to furnish voluntarily more useful information by product lines, a trend which we believe should be encouraged.

Under our present requirements for a description of business done by a diversified company, we seek appropriate disclosures where the contribution of a line of products or services to sales and revenues is not proportionate to the contribution to earnings by that line. We also consider whether other information of material importance in appraising the financial position, the operating results, or its future prospects of a company may

---

3/ Letter of June 4, 1965, and memorandum to Senator Philip A. Hart, page 1069, Part 2, Economic Concentration.

be obscured by consolidated financial statements. But we do not intend by this to minimize the need for consolidated statements (see Rule 14a-3 which emphasizes the need for such statements). An example of the type of additional disclosure obtained under these rules is a company's representation, in a 1965 registration statement, that the contribution of each of three specified activities to net earnings has varied substantially from year to year during the past five years and is not necessarily related to the sales volumes of the three activities. Occasionally an issuer has made additional disclosures of diversified operations in filings with the SEC, but usually they have been made in a most general way.

In a speech in May 1966, the Chairman stated that the diversified enterprise, which was once considered unusual, has now become commonplace yet there has been no significant change in financial reporting requirements to provide the kind of information needed to evaluate the experiences and prospects of such companies. He noted that there have been some voluntary improvements, particularly in the breakdowns of sales or revenues, and that there is some precedent for extension of our requirements in proposals introduced in the English Parliament. He suggested that "we should be looking toward a defined operating profit and loss statement on a divisional basis as the next objective beyond the breakdown of sales for the conglomerate company."[4/] This approach gave recognition to the problems of diversified reporting noted in the memorandum to Senator Hart. In subsequent testimony before Senator Hart's committee in September 1966, the Chairman commented on these problems at some length. His discussion[5/] made the following points:

4/ Address before the Nineteenth Annual Conference of Financial Analysts Federation, published in The Journal of Accountancy, August 1966.

5/ See pages 1986 and 1987, Part 5, Economic Concentration.

1. The basic question of what constitutes a division or line of products for a conglomerate company. In some cases there are no problems in drawing the lines, but as the degree of integration of operations increases the problems become increasingly difficult and further study will be required to develop any requirements for breakdowns.

2. The lack of a satisfactory overall definition of a line of products or services and the fact that the unit indicated on corporation organization charts will not always be acceptable. There may be serious problems in relating operations of a division to standardized codes such as the Standard Industry Code. In some cases a three-digit classification may be too broad and in others it may not be broad enough. A pertinent comment on this problem was made by Professor Adolph E. Grunewald of Michigan State University in an article entitled "Computer Assisted Investment Analysis," which appeared in the Spring 1967 issue of MSU Business Topics. It reads:

> "Stocks have traditionally been classified by industry and probably this system continues to be meaningful. However, with the growth of the large enterprise encompassing many diverse operating divisions, the dividing lines between industries have become distinctly blurred. In both the university and financial communities this is being recognized and efforts are being made to classify stocks in more meaningful ways."

3. The question of how important a particular division must be in the overall picture of a company before separate earnings figures should be required. A rule based on a percentage test might, in some cases, require a smaller conglomerate company to disclose the results of its operations in a certain line of business while a larger company would not have to disclose results for a similar line that was as large or larger because it was not a significant part of the overall business.

4. Other difficult problems relating to the determination of the results of operations for a line of business, such as the segregation of sales when many are intercompany, separation of production costs when there are by-products or joint facilities are used, and the allocation on arbitrary bases of costs of a general nature--administration, research, interest.

5. He also stressed that, in attempting to get maximum disclosure, we must be careful not to encourage disclosures which may mislead investors by appearing to be more meaningful than they really are.

Up to this time professional literature on this subject has been concerned primarily with internal management needs and is not too helpful to us in considering the needs of investors. However, we note a considerable increase in writings on the subject, including quite a few letters to the editors and to the Commission in which strong positions are taken, both pro and con. We have consulted with business and professional groups to develop information on which to base our future course of action. We expect the very comprehensive study and survey being conducted under the sponsorship of the Financial Executives Institute, and in cooperation with other sectors of the accounting, finance and industrial community, to be most helpful. And, of course, we are interested in the study by the National Association of Accountants to be discussed later in this session, and the deliberations of the Accounting Principles Board of the AICPA.

We are hopeful that these studies will shed some light on the whole range of problems under consideration: The problem of semantics arising from the use of such terms as conglomerate, diversified, integrated, concentric; the problem of distinctions between various terms indicating a degree of diversity such as line of business, product lines, functional areas, divisional activities, etc.; the problem of cost allocation within a company; and, of course, the overriding question of the degree and type of profit breakdown that will be most useful to the investing public, but which will not be harmful to the interests of the company. There is a danger, however, that in the concentration on defining these nebulous terms that we may lose sight of the real problem of ascertaining what is significant information for diversified operations. The arguments we hear against disclosure of diversified operations are similar to those that were made against the disclosure of sales, cost of sales and gross profits when rules under the 1933 and 1934 Acts were being developed and implemented. With the passage of time those fears proved to be groundless, and I believe that most, if not all, of the fears today regarding additional disclosures will also prove to be unfounded.

The extent to which management is providing more details of its diversified activities on a voluntary basis is most encouraging. Chairman Cohen has urged this, as have leaders of industry and the accounting profession. We have noted considerable improvement in this reporting in the 1966 annual reports. Not only have more companies provided greater details of their sales and revenues, but some have provided varying degrees of breakdowns of profits for their diverse operations. An article entitled "New Disclosures Noted in Annual Reports" in the June 1967 issue of the Financial Executive illustrates many of the techniques used by companies in the more informative reports. A variety of approaches were taken. The Glidden Company through charts and graphs provides a breakdown of sales, net earnings and net assets for three major product lines, and an additional breakdown of the percentage of sales for 10 subdivisions of sales under the three major lines. Greyhound Corporation showed revenues and net profits for nine areas of activities. National Distillers and Chemical reported sales and after tax operating profits for five divisions. Continental Oil separated its net income derived from coal operations from that earned by all other operations and provided a tabular analysis of net income and net assets for four geographical areas--United States, Canada, other western hemisphere and eastern hemisphere. The Singer Company reported sales and earnings for three major classes of product utilization--products for the home, for industry, for business, and an additional breakdown of sales for six major geographical areas. Cutter Laboratories captioned its product lines as human, hospital and veterinary in a breakdown of sales.

These examples suggest that a great deal can be accomplished on a voluntary basis and in an evolutionary manner. To the extent that this is so our task will be easier in the determination of the need for rulemaking in this area of financial reporting.

As I have indicated in this paper we have not as yet developed criteria for line of business reporting, and we do not expect to reach a conclusion until we have had time to evaluate the results of the studies and to consider all the comments that are submitted to us. The first installment of Robert Mautz's study deals with this matter of definition and is scheduled for the July issue of the Financial Executive. However, the following statement by the Chairman gives a clear indication of what we are striving for:

"An increasing number of companies and groups of affiliated companies are spreading themselves over a variety of entirely different kinds of operations, and it is no longer enough for the investing public to know the overall results in consolidated form. If investors are to make meaningful decisions, they must also know the respective contributions of these various categories to the consolidated income figures.

"There is also another aspect I would like you to bear in mind. There seems to be a feeling in some quarters that the only people who have any interest in obtaining this information or could use it effectively are the financial analysts, whose appetite for financial information is considered to be virtually insatiable. I do not think this is a valid criticism. In the first place, some sort of divisional breakdown may make it easier for the relatively unsophisticated investor to judge the merits of a particular company. In the second place, disclosure of this kind of information, like all disclosures under the securities acts, serves a number of purposes. It not only informs the investor or his adviser but also serves as an important control on corporate managers by requiring them to justify the results of their stewardship. There may be diversified companies which are maintaining low-profit or money-losing operations for reasons which would not be persuasive to stockholders or financial analysts, and requiring separate disclosure might well result in the improvement or elimination of the substandard operation, to the ultimate benefit of the stockholders and of the economy generally. Finally, we may well find, as we have in other areas, that a requirement of public disclosure will result in improvements in internal accounting procedures that will provide the company managements themselves with more useful information to evaluate the performance of their various divisions." 6/

To sum up, it appears that the ways of presenting useful information on diversified operations are about as diversified as the operations. The significant points seem to be that the sources of income and their relative profitability, particularly with respect to variations in profitability, the variations from expected returns from the type of operation engaged in and the general prospects of the operation, such as phasing-out or phasing-in, are matters deserving of informative disclosure.

--oo0oo--

6/ Address before the Seventy-ninth Annual Meeting of the AICPA on October 5, 1966, published in The Journal of Accountancy, December 1966.