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DIVISIONAL REPORTING BY DIVERSIFIED CORPORATIONS: AN ACCOUNTANT'S VIEW

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Over the past few years, corporate reporting practices have been the subject of considerable public attention and widespread discussion in the business community. The accounting profession, although directing its attention to many different corporate reporting practices, has given special attention to the traditional methods of reporting results of operations for the firm loosely referenced as a "conglomerate."

THE BASIC FINANCIAL REPORTING PROBLEM

The acquisition of one company by another is a phenomenon that has been common in the business community for decades. Twenty or so years ago most of these acquisitions were consummated to achieve growth within a company's basic lines of business and very few mergers involved companies in unrelated businesses. In 1968, however, over 50 percent of all mergers involved companies with nothing in common.[1] This new type of merger and the increased merger activity in recent years have led the accounting profession to question the adequacy of its financial reporting.

The growing conglomeration of companies has seriously reduced the quantity, quality, and usefulness of published financial statements. Each time one company merges with another company in a related industry, one company ceases to publish separate financial statements and the amount of financial information available about the industry is correspondingly reduced. In addition, the surviving company often publishes financial statements which report only the results of total operations and present little or no information about the underlying segments of the company. If the merged companies are in unrelated industries not only is the amount of financial information reduced but the consolidated reports of results of operations are less useful, especially for comparing current operations with past operations, because they reflect consolidated results of diverse activities. This raises the question: How much and what financial information does the financial analyst need to effectively evaluate the operations of the conglomerate?

It is logical to expect that the financial analyst will want financial information for the conglomerate presented in such a way that he can make analyses by basic product lines or industries. For example, the financial

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1 Pacter, *Conglomerate Reporting—The Debate Continues*, 127 J. ACCOUNTANCY 24 (1969).

analyst analyzing conglomerate *B*, which resulted from the merger of *A* and *B*, will continue to desire information on the operations of basic *A* and basic *B*. This information should be detailed enough to enable the analyst to appraise past performance and future prospects by broad product line.

Reporting Alternatives

There are four broad possibilities for reporting results of operations by product lines for conglomerates:

(1) report all revenues and expenses divided by component,
(2) report only sales, cost of goods sold, gross profit, and direct operating expenses by component,
(3) report only sales, cost of goods sold, and gross profit by component,
(4) report only sales by component.

Of the four possibilities, the first, report total net income (all revenues and expenses) divided by component, appears to be not only impractical from an accounting standpoint, but also unrealistic for many conglomerates. To so report would require that all expenses be related in some way to the various components. In practice, there are many instances where such a division would require estimates, assumptions, and arbitrary allocations to such an extent that the resulting information would not only be meaningless but could be misleading. For example, with rare exceptions, the various divisions of a conglomerate employ many inputs jointly: managerial talent, finances, etc. Identification of such joint costs with individual components is almost certain to be arbitrary and the component net income figures would therefore be useless and perhaps misleading. Obviously, such reports should be avoided. The other three reporting possibilities avoid the arbitrary allocation of such common or joint costs.

In the study, *External Reporting for Segments of a Business*,[2] it was reported that executives with diversified or conglomerate companies expressed opposition to the disclosure of segmented profits but accepted segmented sales reporting. These executives opposed segmented profit reporting primarily because they believed that such procedures would disclose information which might be useful to competitors and thus be detrimental to the company. The author feels that this is asking, unnecessarily, for too much secrecy. I contend that the practice of publishing only segmented sales data and no information on segmented expenses denies the financial analyst information necessary to the proper analysis of the business. For example, without such information how can the analyst determine whether or not high profits in one segment subsidize other activities and keep the corporation from realizing the highest possible corporate profits?

Corporate reporting, therefore, should be carried beyond reporting only segmented sales figures. As a minimum the conglomerate should report

2 M. Backer & W. McFarland, External Reporting for Segments of a Business (1968).

sales, cost of goods sold, and gross profit by component. However, a superior method of presenting divisional operating data would be the contribution form of income statement where sales, cost of goods sold, gross profit, and direct operating expenses are reported by segment or component. Such an income statement, which is illustrated below, would indicate in an explicit manner the contribution made by the various components to the overall performance of the company. It should, however, be clear from the format of the statement that (1) any evaluation of the component must be in terms of its contribution to overall business operations since each component represents only a part of the larger business unit, and (2) each component makes an uneven contribution to indirect corporate expenses and corporate profits.

INCOME STATEMENT REPORTING CONTRIBUTION MARGIN FOR COMPONENT
X Company
Income Statement (000 omitted) For Year Ended December 31, 19—

	Product A	Product B	Total
Net sales	$272,400	$116,900	$389,300
Cost of goods sold	148,500	77,600	226,100
Gross profit	$123,900	$ 39,300	$163,200
Direct expenses	36,800	21,050	57,850
Contribution margin	$ 87,100	$ 18,250	$105,350
Indirect expenses			50,750
Net income from operations			$ 54,600
Interest expense			1,200
Income before income tax			$ 53,400
Income tax			19,132
Net income (per share, $2.21)			$ 34,268

CURRENT REPORTING PRACTICES

The position of the accounting profession on the matter of published reports of operating results of conglomerate companies is expressed by the Accounting Principles Board of the American Institute of Certified Public Accountants in their 1967 *Statement* entitled *Disclosure of Supplemental Financial Information by Diversified Companies.*[3] In the *Statement,* which is a special report for the information and assistance of members of the Institute, the Board states:

> the term conglomerates is used popularly to describe a company that diversifies into distinctly different industries by acquisition or merger. The Board believes, however, that there is little distinction between industry diversification which arises by this method and industry diversification resulting from a company's own internal development and expansion efforts. All of these companies will be referred to in this statement by the more descriptive term diversified companies.

[3] AICPA, *Disclosure of Supplemental Financial Information by Diversified Companies,* APB STAT. (1967).

> Disclosure of financial data relating to separable industry activities of a diversified company has not been considered essential for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles. The Board recognizes, however, that financial reporting practices are not static and should be responsive to changes in the business environment. The increase in industry diversification by business enterprises is one aspect of the changing business environment which indicates a need for reexamination of financial reporting practices.[4]

The Board goes on to state that before it can issue a definitive pronouncement on the subject, further research is necessary to provide practical guidelines for determining the extent to which segmented reporting is needed by investors for reliable investment decisions, is not harmful to the company, and is necessary for fair presentation of results of operations. In the interim the Board recommends that each diversified company review its own circumstances carefully and objectively with a view towards providing supplementary financial information as to industry segments of the business.

The Securities and Exchange Commission (SEC), on the other hand, has set forth certain reporting practices for conglomerates. These requirements, published in two releases,[5] detail amendments to Forms S-1, S-7 and 10, the annual forms which must be filed with the SEC or in forms which must be filed as part of a registration or proxy. The cover letter from the Secretary of the Commission accompanying the releases referred to a prior proposal on this subject and the reaction of the business community to the proposals. The letter set forth the following summary of the releases:

> Where a registrant and its subsidiaries are engaged in more than one line of business, the amendments require the disclosure for each of a maximum of the last five fiscal years subsequent to December 31, 1966, of the approximate amount or percentage of total sales and operating revenues and of contribution to income before income taxes and extraordinary items attributable to each line of business which contributed, during either of the last two fiscal years, a certain proportion to (1) the total of sales and revenues, or (2) income before taxes and extraordinary items. For companies with total sales and revenues over $50 million, the proportion will be 10 percent; for smaller companies, 15 percent. Similar disclosure is also required with respect to any line of business which resulted in a loss of 10 percent or more (or 15 percent or more for smaller companies) of such income before deduction of losses. Where the percentage test as applied to both sales and earnings contributions results in more than ten lines of business, the disclosure may be limited to the ten most important lines. Where it is not practicable to state the contribution to income before income taxes and extraordinary items for any line of business, the contribution to the results of operations most closely approaching such income is to be disclosed.
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> Various suggestions were made for more specific indications of the

[4] *Id.* at 1.

[5] Mautz, *Bases for More Detailed Reporting by Diversified Companies*, FINANCIAL EXECUTIVE, Nov. 1967, at 52-60.

> 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 responsive to its organizational concepts.[6]

CONCLUSION

The extension in financial reporting for conglomerates, as required by the recent SEC requirements, represents a step forward in the advancement of financial reporting. However, more stringent requirements are necessary in two areas: a definition of a "component" or "line of business" should be specified and the reporting of contribution margin by component should be made a reporting requirement. In addition, requirements similar to these established by the SEC, should be adopted by the accounting profession for published financial statements for conglomerates.

The SEC left to management the selection of a reasonable basis for separating the conglomerate into components. This is unacceptable because even the most scrupulous management is likely to lack the objectivity needed to fairly make the decision. In addition, as any student of accounting knows, far too often in current practice management has exercised its judgment by the selection from among acceptable alternative procedures, methods which do not result in the fairest disclosure of operating results. The SEC proposal only adds to the list another alternative accounting procedure available to management, all of which make it extremely difficult to evaluate the company's activities and compare these activities with those of other companies.

The SEC also leaves to the discretion of management the determination of a reporting pattern appropriate to its operations. If management determines that it is not practical to state the contribution to income for any line of business, it can report the contribution to the results of operations most closely approaching such income. The potential for abuse here is too obvious to warrant comment. In addition, with different companies electing various stages of contributions for reporting purposes, the comparison of one company's results with other companies becomes that much more difficult. This recommendation does not seem to be much of an improvement over the reporting practice that existed before the SEC release when it was left to the discretion of the company as to whether component reporting was to be followed.

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[6] Letter from SEC Secretary Orville L. DuBois, July 14, 1969, accompanying releases, *supra* note 5.

What is needed then, is the requirement to report the contribution margin by well-defined segments. The application of the contribution margin technique of accounting to conglomerates will present few practical accounting problems. The major problem is to achieve agreement as to the definition of a segment. Unfortunately, there is no standard classification at present that is satisfactory for this purpose.[7] This means that representatives from the accounting profession, the investment community, and industry will have to get together and devise such a classification which will serve as a clear-cut guideline so that conglomerates (diversified companies) can provide reports containing the type of information the analyst needs to effectively evaluate the company. Without such definitive reporting standards, the most useful component reporting will not be provided to the financial analyst.

[7] R. Mautz, Financial Reporting by Diversified Companies (Fin. Exec. Inst. Study 1968).