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DIVISIONAL REPORTING BY DIVERSIFIED CORPORATIONS: AN ANALYST'S VIEW

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With the growth of financial markets and the broadening of stock ownership, new rules have been needed to improve the investment process. The size and complexity of business have produced confusion. How can an investor simplify complex companies and understand the economic forces at work?

The answer is to isolate the leading factors, to break out the trends at work, to show the strong points as well as the weak points. Divisional data may enable investors to focus more precisely and to do better research on the salient features of a company. The investor may then be less imbued with concepts, such as pollution, and instilled with a better awareness of the economics of an industry.

Why should the investor be better informed? There are believed to be about 26 million Americans with security holdings. Many others are indirectly affected by pension benefits. The dollars invested by these people, the owners of the business, reach $661 billion, for the New York Stock Exchange alone. The institutionalization of investment in the United States may be one of the greatest forces for general good; it is indeed remarkable.

To what extent do analysts try to use this approach of divisional results?

When the food analyst appraises Ralston Purina, he assesses the gross margin on (1) soybeans and meal; (2) poultry, and the price of hogs and steers. (This illustration was first used in 1967 when these trends were most unfavorable; today the picture may be reversed.) When the electrical equipment group — say General Electric — is analyzed, we break the company into more meaningful components. There may well be over one hundred profit centers, but remember, we are only concerned with material contributors, say 10 percent or more of the net. This may well require a lumping or aggregating of related areas.

At General Telephone, once again a divisional approach is required on telephone operations and then the various manufacturing sectors.

In short, we seek to break down large aggregates into smaller sectors with homogeneous parts. It is then necessary to find the central economic feature underlying each division. Are prices the key; gross margins; added volume; new technology? Of course, in major companies such as General Electric, a general grouping such as "utility" covers countless products — generating, transmission, distribution — with varying margins, growth rates

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and degree of risk. Nonetheless, an investor is put on notice that the economic features here differ from a category of "defense" or "industrial."

Management breakdown

Quite naturally management is expected to decide upon the breakdown of operations. This is logical and proper; management after all is in a position to know most about its own operations. Management is accustomed to running its business, receiving reports on operations, and making policy decisions. The information sought is a very normal outgrowth.

Competitive Secrets

At the same time no industrial secrets will be given to competitors. Costs of production of particular products are not disclosed. Groupings are to be made of fairly large size.

Thus, from the Litton report for fiscal 1969:[1]

	Sales & Service Revenues by Product Line	Operating Profit (before interest taxes, etc.)
Business systems & equipment	$607,703,000	$32,607,000
Defense & marine systems	570,078,000	45,681,000
Industrial systems & equipment	656,970,000	64,750,000
Professional services & equipment	372,887,000	37,974,000

Surely even as small a breakdown as $373 million of sales with a 10 percent margin covers a multiplicity of products and trends. Yet it is a start towards improved analysis. Parenthetically, a Litton executive decried the proposal for divisional earnings a few years ago.

1 1969 Annual Report of Litton Industries — Financial statement, § 21.

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Product groups & operating units	Sales	Income before federal income taxes
Electrical	$143,767,000	$20,818,000
Consumer & consumer durable	79,144,000	17,321,000
Automotive	128,431,000	11,314,000
Compressors	72,695,000	8,670,000
Turbines	59,604,000	5,152,000
Pumps	56,079,000	4,980,000
Controls & meters	38,761,000	3,159,000
MLW-Worthington Ltd.	37,468,000	2,060,000
Engineering & contract services	13,790,000	(1,956,000)
Air conditioning, heating and refrigeration	54,664,000	1,468,000
Turbines, compressors & pumps — international	52,745,000	5,569,000
Corporate:		
Intercompany eliminations and adjustments	(27,169,000)	—
	$709,979,000	$78,555,000

1968 Annual Report of Studebaker Worthington Inc. at 13.

Then, too, most people in a field seem to be pretty well aware of the economics of an ammonia plant, or costs of marketing gasoline. Trade publications, engineering studies and consultants are all available to provide professional investors — let alone industrial managers — with such data.

It should also be clear from the Litton illustration or Studebaker,[2] that we do not expect investors to compare the business systems division of Litton with that of IBM. The product mix of each company may be unique. The value of divisional earnings will be in understanding a company, with comparisons a minor element.

How wisely will the information be used? This, of course, is impossible to determine in advance. If indeed the added data is too complex for the average shareholder, it may still be a boon to what the Wheat report calls the financial intermediary, *i.e.*, the financial analyst at the brokerage house or institution who stands ready to examine and question.

Will such disclosure result in a chorus of shareholder criticism, inhibiting management from risk-taking, thereby depriving the economy and shareholders of new developments? I know of few companies particularly responsive to the howls of the mob. The move to corporate democracy has resulted in one-day-a-year exhibitionists and other gadflies dealing in a host of trivia. I think few executives take this seriously. But if the overseas efforts of Deere & Co. go on year after year with little sign of improvement, don't shareholders have the right to question management — when will this reach the breakeven — why hasn't it — what can be done to improve operations — what is the ultimate potential?

Interestingly, I think that when a new management goes into a sick company, one of the first steps is to review and establish cost centers, to find out where the problems lie — why the rate of return is disappointing. I find managements impressive when they exhibit an awareness of these divisions; they know where to focus their attention. The more you know about your business, the better off you are.

Conclusion

It is clear that each business has sectors with different trends, different margins, different rates of growth, different risks. Breaking these out for the investor, showing comparative profits year after year, should result in more precise and more accurate study of economic factors. With knowledge and understanding, we may improve the investment process. Indeed, it is the writer's hope that we now have a significant and powerful new tool that will be invaluable in future years.