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DIVISIONAL REPORTING BY DIVERSIFIED CORPORATIONS: A BUSINESSMAN'S VIEW

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Few issues in the field of corporate finance have been more controversial in recent years than the question of complete disclosure of revenues and earnings in terms of specific dollars-and-cents amounts by separate units of diversified companies. Relative importance of various divisions to overall corporate performance has long been a matter of concern to internal managements and analysts. Until recently this information has been closely guarded and available only to the Securities and Exhange Commission (SEC) at the time of filing securities registration statements.

As a matter of fact, filing of such information was not actually required until new amendments to the Securities Act of 1933 became effective on August 14, 1969.[1] These amendments, announced after some four years of deliberation, provide that a company engaged in more than one business activity must disclose the approximate amount or percentage of total sales and operating revenues and of contributions to income before income taxes and extraordinary items attributable to each business line for all fiscal years subsequent to December 31, 1966.

Companies with total sales and revenues of more than $50 million must submit breakdowns for each line of business contributing more than 10 percent to operating revenues or income, or resulting in a loss of 10 percent or more. For companies with annual sales of less than $50 million, the benchmark level is 15 percent of profits or sales (or losses) instead of 10 percent. If the percentage factor, applied to both sales and earnings contributions, results in more than 10 lines of business, disclosure may be limited to what the company considers its 10 most important lines. Where it is not possible to break down the contribution to income before taxes and extraordinary items for any business line, the contribution to operational results most closely approaching such income must be disclosed, accompanied by an explanation why the company cannot state the income contributions.

At first reading, these amendments present no insurmountable problems. However, the SEC rules prescribe no guidelines as to what constitutes a "line of business." Nor will the SEC define the term. Appropriate consideration, it was suggested, should be given all relevant factors, including rates and profitability of operations, degrees of risk and opportunity for growth. But discretion becomes that of management, according to the SEC release, to define a reporting pattern in line with a company's particular operations and responsive to its organizational concept. A descrip-

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[1] INSTITUTIONAL INVESTOR, Oct. 1969, at 20.

tion of the basis for grouping products into a particular line must be given, however, and changes in product lines between reporting periods described.

The revised form, in general, continues existing disclosure requirements on breakdown of total volume of sales and revenues by principal classes of similar products or services. At present, however, this breakdown can be expressed only in terms of sales percentage and does not have to include contributions to net income.

The new SEC rules have actually been anticipated by some companies which have made public sales breakdowns of their various components by category. A study in 1968 by the Financial Executives Institute, for instance, showed that 48 percent of 457 publicly-owned companies surveyed reported contributions to gross sales made by division, major markets, geographical areas (domestic), product lines or operating groups.[2] But these breakdowns, while significant in view of an absence of such practice a few years ago, customarily cover broad product categories — such as "consumer," "industrial," or "government" — without indicating which internal units were responsible for such sales or losses. Such groupings arbitrarily selected by management tend to mask individual profits and losses of subsidiaries and divisions.

Regardless of any deficiencies in current rules and practices, the SEC now wants to apply such criteria to the detailed annual financial reports publicly-held companies must submit to. The agency gave "interested parties" (until November 23, 1969) an opportunity to comment on the changes, but there seems little doubt that the present disclosure rules will soon become effective for all such annual reports to the agency.

What is behind the current movement to disclose more? According to *Financial Executive*,

> it is partly the result of pressure exerted on corporate management by stock analysts, financial institutions, shareholder groups, and, to some degree, the firm's own public accountants. In addition, a number of professional organizations, including Financial Executives Institute (and the American Institute of Certified Public Accountants), have supported the principle of additional voluntary disclosure of financial information by corporations.[3]

The most pointed pressure has been exerted by the SEC,

> which has, in numerous statements, articles and speeches by its personnel, campaigned for greater voluntary disclosure by publicly owned corporations. During this time the SEC has repeatedly noted that if such information

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[2] Hobgood, *Voluntary Disclosure in 1968 Annual Reports*, 37 FINANCIAL EXECUTIVE, May 1969, at 64.

[3] Savoie, *Financial Communication: The Public's Right to Know*, 36 FINANCIAL EXECUTIVE, Dec. 1968, at 21.

were not disclosed voluntarily, formal rulings might well be issued which would require corporations to show financial information in the report to shareholders.[4]

Thus far, the SEC's rules, as indicated above, apply only to certain registration statements filed with the Commission. But the SEC continues to study whether and to what extent similar disclosure requirements should also be applied to periodic reports. A recent study (the *Wheat Report*) which the Commission issued urges that these requirements be extended to the annual 10-K reports filed by corporations with the SEC.[5] Traditionally, the 10-K report requirements are regarded as harbingers of later revised requirements for stockholder reports, since the SEC normally requires that reports sent to shareholders not differ materially from those filed with it.

Both the amended regulations to date as well as hints of future and stronger disclosure requirements have stimulated considerable resistance among top managements of many diversified companies. Some state privately that the relative planned obscurity of their financial statements help protect them from "stupid but embarrassing" questions at annual meetings. Other more serious objectors complain that such full disclosure would:

1. Help competitors, especially those in businesses with a high rate of new product development;
2. Involve too many wild guesses to be meaningful to investors; and,
3. Cost overwhelming amounts of accounting time.

The reluctance to disclose such profit data is widespread; only 9 percent of the companies queried in the Financial Executives Institute survey did so in their 1967 annual reports.[6] Yet, were any subsidiaries (some of which functioned previously as public corporations) still filing reports, they would have been compelled to indicate sales and profits to their shareholders in their annual reports.

Admittedly, it is necessary to assign costs such as taxes, interest and overhead which are normally carried by the corporation as a whole rather than by any single group or division. For example, two divisional managers of an east coast bus company complained that each was claiming his division was "carrying" the other. The argument surrounded allocation of overhead costs for a terminal used by both divisions. Should the cost be divided in proportion to the revenue brought in by each division? Should it be based on the amount of space used by each? Or should it be determined for each division by calculating what the costs would be if the other division ceased to operate? While initial accounting studies pro-

[4] Hobgood, *supra* note 2.
[5] *Id.*
[6] *Id.* at 65.

duced wildly varying results, a final study coordinated with management settled the dispute amicably. A simple solution would be to show operations of each subsidiary before taxes as though each subsidiary was functioning as an independent entity.

Diversified companies which are highly decentralized generally have fewer problems allocating such overhead costs. For several years, Textron, Inc., Providence, Rhode Island, an original multi-market company, has been breaking down sales and pre-tax profits of each of its four operating groups — aerospace, consumer products, industrial goods and metal products. Since the corporate headquarters numbers only 100 people and the company conducts no large interdivisional sales, most costs can be readily allocated to a single operation.[7] The exception is taxes, which Textron absorbs as a corporate expense.

On the competitive side, one large conglomerate manufactures products which have profit margins ranging from 2 percent to 52 percent.[8] Once the high profit items become well known, the company can be in trouble from two sources — large customers and competitors. Customers could demand price reductions or threaten to cancel orders. Competitors can know precisely where to strike for new business. These are "warmed over" arguments against disclosure which were used unsuccessfully in 1933 when the principle of full disclosure and the SEC were first established.

In another instance, a president of a diversified company complains that the new reporting guidelines would reveal its sales and profit data to a larger competitor, while what the competitor discloses would be of little value. His company makes a computer which is responsible for more than 10 percent of its sales. He thinks International Business Machines (IBM) probably sells three times as many of its similar computer — but that product comprises much less than 10 percent of IBM's sales. Under the regulations, IBM would learn all about its smaller competitor which would find out nothing about IBM.

Although it is true that competitive pressures may be brought on certain companies operating under the new rules, the settling effect of market changes should serve to equalize any disbalances which may temporarily occur. At any rate, the SEC, which must itself be vigilant against stimulating "unfair competition," indicates it is not very concerned about corporate complaints that the new rules will result in profit-cutting competition.[9] Here we are confronted with a choice between "cartelism" and the private enterprise system which competition has made successful in the United States.

Adherence to the new SEC guidelines will require, perhaps, concen-

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[7] TEXTRON, INC., 1967 ANNUAL REPORT (1968).

[8] L.A. Times, Jan. 5, 1969, § F, at 1, col. 1.

[9] Wall Street Journal, Nov. 5, 1969, at 18, col. 3.

trated review of a company's accounting procedures, but many corporate executives and auditors do not believe there is any justification for the belief that the required breakdowns will result in wild guesses or misleading information. Initially, of course, accounting costs will be higher than under previous practices which did not disclose divisional sales, costs and earnings. The cost of accounting as required under full disclosure rules is the weakest argument mustered.

Objections of diversified companies to such full disclosure as the SEC and other organizations now recommend seem based on pre-1933 rationale which may either be obsolete or, occasionally, perhaps intentionally misleading. While those most heartily campaigning for dollars-and-cents disclosure — the financial community and those associated with it — are met with hard-line negative reasons opposing such moves, the fact remains that those most intimately affected, the shareholders, have received little consideration in the controversy.

It is my personal conviction, and that of the management of our company, that since we must disclose such detailed information in registration statements, we should also share this information with the stockholder members of our own family. We do not feel that such public unveiling of heretofore hidden corporate financial figures can do other than reinforce stockholder loyalty and indicate to the financial community that we live in a goldfish bowl and we are happy with our environment.

Through the complete and precise departmental disclosures included in Standard Prudential Corporation's *1969 Annual Report*, for instance, we are attempting to make possible an accurate, meaningful evaluation of the progress and profitability of each unit by shareholders, analysts, portfolio managers and the financial press.

In so doing, we believe we are pioneering even beyond current and anticipated requirements. That means, to date only detailed breakdowns of sales volume and profits by any substantial diversified company have been reported in percentages by constituent groups or industry categories but not in dollars and cents of each individual subsidiary or division of importance. Thus, groupings are made under such broad and vague headings as "consumer" or "industrial." In practice, this has appeared to be a somewhat radical departure from previous practice. Actually, however, a corporation can hide poor performance of one or more subsidiaries on low or negative contribution to profitability under such a blanket heading which, in total, becomes a composite financial facade.

Thus, it was with some true sense of corporate satisfaction that we read in the *Wall Street Journal* on October 9, 1969, that, "Standard Prudential Corporation lifted a traditional corporate veil in its annual report for fiscal 1969, disclosing detailed dollar results of its nine separate units."[10]

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[10] *Id.*, Oct. 9, 1969, at 36, col. 4.

It stated that we believed, "the breakdown is the most complete ever reported by a large, diversified corporation."[11]

Similar tributes from the financial press have been received in increasing numbers since publication of our annual report. Our constructive disclosure action was taken neither as a novelty nor in anticipation of more stringent SEC regulations possibly to come. On the contrary, we took this move after long deliberation of the consequences both to Standard Prudential as a corporation, to the whole area of publicly-held companies and for the benefit of our shareholders and financial analysts.

We had to consider negatives, of course. Our overall net sales increased to $104.7 million, with a net income of $4.2 million, or 49 cents a share, from sales of $106.8 million, and a net of $3.8 million, or 26 cents a share for the previous fiscal year.[12] At the same time, however, two of our separate units suffered losses in fiscal 1969. Fabrics by Joyce, Inc., lost $1,168 on sales of more than $18 million. United Communications, Inc., lost $23,610 on revenues of $2.3 million.[13]

We thus reported that, while our net income had increased appreciably over the previous year, we had two sore spots about which, in all corporate candor, we were compelled to inform our shareholders. Naturally, remedial measures have already been put into effect, as our first quarter statement for fiscal 1970 indicated. Yet we felt we had no other recourse but to report which of our nine subsidiaries were making money and which were losing.

Reaction to implementation of our full disclosure policy has been uniformly favorable. Wall Street circles, the press, a former important official of the SEC and, best of all, our own shareholders have applauded this move to keep them better informed about the progress of the company.

We hope this innovation will be rapidly adopted by other large diversified companies so that investment decisions and evaluations of corporations may be made wisely and prudently. When I refer to other large diversified corporations, I have in mind companies that are not necessarily defined as "conglomerates" but nevertheless operate many subsidiaries or divisions engaged in businesses unrelated to the original single product by which they were originally identified. Such corporations are among the top hundred companies in the United States.

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11 STANDARD PRUDENTIAL CORP., 1969 ANNUAL REPORT at 1 (1970).

12 *Id.* at 8.

13 *Id.*