

ADDRESS BY

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I am pleased to be here this morning before so many representatives of our customers. I am particularly pleased to join Bob Haack and to congratulate the New York Stock Exchange community for the far-sighted action it has taken under his leadership. It was also with some anticipation that I looked forward to meeting Mr. Charles Bluhdorn about whom I have heard so much. He represents, in the view of many, a relatively new breed of businessmen. The financial press in recent times has given a great deal of attention to their feats of corporate legerdemain, and to their breathtaking balancing acts. The emphasis in the press and elsewhere on his activities, and those of several others similarly engaged has, however, diverted attention from what can only be described as a revolution in American business; I am talking about the tremendous increase in the number of public companies which have been diversifying into unrelated areas of operation. These highly publicized activities reflect, however, only a fraction of the increasing number of acquisitions and mergers involving companies in widely different lines of business. And, of course, many companies over the years have diversified through internal programs. This accelerating trend is changing the face of industry in the United States and abroad.

Now where does this trend leave the public investor without whom much of it would be impossible? All too often, he is left in the dark, particularly when these companies publish financial statements only on an overall company basis. It has been urged that investors and the marketplace need more detailed information, particularly concerning the relative contributions of the various lines of business, if meaningful investment decisions are to be made.

Not unexpectedly, some of those who may be called upon to furnish this information have quarreled with the idea of categorizing the diversified company into its principal business lines. In their view, the investor is (or should be) interested, not in information concerning the component parts, but only in the consolidated figures.

The Commission too has recognized the importance of disclosure of overall operating results. I refer to the development, after a long struggle, of the requirement for consolidated statements in any presentation of the financial position of a corporation and its affiliated companies. But this development, in the context of the rapid changes in the last several years, has been a bit too successful.

A disclosure problem does arise when a company or group of affiliated companies in an integrated line of business decides to diversify into unrelated areas. The investor or his adviser, in such cases, no longer receives information previously available to him from the financial statements of the acquired companies. Presentation of information in consolidated form concerning the combined businesses may conceal significant information. The prospects of a

conglomerate enterprise are not measured simply by a figure which reports the total profitability of the enterprise. The past history and changes in profitability of the significant segments are essential to any realistic evaluation of its recent experience and any assessment of its prospects.

Corporate earnings, unlike dollars, have a quality as well as a quantity. Few would suggest that a dollar per share earnings in a "Wildcat Oil Company," with a most erratic performance, and a dollar per share earnings in General Motors have the same worth and significance to investors. The value of earnings is based, at least in part on risk, profitability and growth potential of the business. A conglomerate company, is in fact, a number of disparate businesses each of which may represent different degrees of risk, profitability and opportunity for growth. In these circumstances, unless adequate information concerning these segments is provided, it is, at the very least, difficult to make meaningful investment judgments.

We have always recognized that a reasonable breakdown is essential to meaningful evaluation of past, and informed assessment of future, performance. Wholly apart from the importance of such information to investors, its disclosure is a potent stimulant to the improvement or elimination of substandard operations. The lack of relevant information and the attendant investor frustration can result in a failure of confidence which could have serious consequences for the stability and credit standing of the company. In recent times, certain conglomerates have experienced such a failure, with consequent sharp declines in the market prices of their securities. Undoubtedly, other factors contributed to this result. I believe, however, that the lack of adequate and material information, suitably broken down for the separate business segments, has been an important factor.

Public skepticism about the performance of certain conglomerates has also been attributed to uncertainty whether reported earnings reflect increasing profitability of the company's operations or are merely the result of the accounting treatment accorded recent acquisitions. Whatever a breakdown may show about the profit or lack thereof of the separate business operations of the company, I suggest that history supports the view--already adopted as a matter of practice and law in certain foreign jurisdictions--that the diversified company can only gain public confidence when the material facts about its operations are fully disclosed. Last week I was privileged to discuss this very problem with the Society of Investment Analysts in London, many of whom expressed surprise that British practice was so much further advanced than ours (and that there was some opposition to the provision of relevant material information).

I have heard that some corporate officials feel the Commission concern for improved disclosure is part of a government-wide effort to put a damper on the growth of diversified companies. I know of no such effort. There has, of course, been much interest expressed by certain government officials in the various branches of government in the increased pace and the newer forms of combinations. I must emphasize that the concern of the SEC in better disclosure has no secondary anti-trust or tax enforcement motive. It is, solely and simply, a part of our continuing effort to provide meaningful information to the investing public. The fact that conglomerates are of growing importance, and are usually actively traded, emphasizes the necessity for such information.

I should note, as I have elsewhere, that improved disclosure in this area is not without its problems. Indirect costs of the enterprise must be allocated in such a manner as to make the separate profit and loss figures not misleading. However, whatever the problems of making equitable allocations of costs, they are not insoluble. Nor do they provide a reason for abandoning the effort for improved disclosure. I must repeat that, without adequate information concerning the separate business lines of a company--and I emphasize that we are not talking about each and every product--the investor or his adviser will be handicapped in his analysis of the company's prospects. With or without such information, he must still arrive at some judgment about the prospects of the enterprise, or give up the attempt. That, after all, is what investing or investment management is all about.

Of course, we have always had companies conducting widely different operations. And, as you know, the Commission has for many years, required such companies to provide information in registration statements regarding 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. It was over two years ago that the American Institute of Certified Public Accountants' Committee on Relations with the S.E.C. and Stock Exchanges, at my request, made a survey of the disclosure problems of diversified companies. At the end of September, 1966 the Committee issued its report. At about that time the F.E.I. proposed to the Commission that it initiate and finance a study. We agreed to defer action pending the completion of the report. In the meantime, I urged voluntary disclosure in numerous public statements, and the Accounting Principles Board, in a statement entitled "Disclosure of Supplemental Financial Information by Diversified Companies," Issued in September, 1967, encouraged diversified companies to disclose voluntarily "supplemental financial information as to industry segments of the business."

These efforts to achieve voluntary disclosure have had mixed results. In a survey of 1966 reports to stockholders, we noted some progress. Our review of 1967 reports indicates additional progress, but not to the extent we hoped to see. Where improvements were made, we noted many examples of informative disclosures; relative contributions to net income; relative contributions to net income before allocation of corporate overhead taxes and other items; and relative "operating profits" of the various divisions.

Our Division of Corporation Finance has also reported more informative disclosures in registration statements. Certain companies, for example, have given the approximate percentage of contributions to consolidated net income of each major product group. Others have presented tables showing sales and net income for significant segments of the business in actual dollar amounts. Still other companies have disclosed major differences between contributions to sales and earnings and have specifically mentioned material segments of the business which had operated at a loss. We believe much more can be done along these lines, by many companies. It may not be amiss to note that the Companies Law in the United Kingdom was amended in 1967 to require such information and more. This followed the adoption of similar requirements by the London Stock Exchange.

In the two years since the F.E.I. proposed its study on disclosure, many worthwhile articles and statements on this subject have been prepared by professional groups and by

individuals. In recent months three important studies have been published. The F.E.I.'s comprehensive study was published in June under the title Financial Reporting by Diversified Companies. The proceedings of a two-day conference on the subject, held at Tulane University last fall, were published last spring as was the report of a study conducted by the National Association of Accountants. With all this material available, much of it stimulated by the Commission, our staff undertook to draft revisions to the description of business items in our registration forms as they relate to diversified companies. On September 4, the Commission published for public comment a proposal to amend the description of the business item in Forms S-1 and S-7 used for registration of securities under the Securities Act of 1933 and Form 10 for registration of securities under the Securities Exchange Act of 1934. Comparable amendments of other disclosure requirements under the 1934 Act have been deferred pending the receipt of comments on these proposals as well as the completion, shortly, of the general study of our disclosure requirements under the Securities Exchange Act of 1934 currently under way in the Commission.

Prior to preparation and publication of the current proposal, the staff conferred with Dr. Mautz, who was responsible for the development of the F.E.I. study, and with the advisory committee that assisted him. Our proposal reflects many helpful suggestions received as a result of this effort and others. If adopted in the form published, it would require information concerning separate classes of related or similar products or services which, during either of the previous two fiscal years, contributed 10% or more to total sales and operating revenue, or to income before extraordinary items and income taxes have been deducted. For these business segments, disclosure would be required of the approximate amount or percentage that each contributed to revenues and to net income for each of the last 5 years. However, if this is not practicable, disclosure of the contribution most closely approaching net income would be required. Comparable data on revenues and earnings received from foreign sources, other than Canada, from government procurement or from any single customer are also to be reported. These latter sources of revenue and income are not dealt with in the F.E.I. report, but we currently obtain information in some form in these areas. Early comments indicate that some editing of the proposal may be necessary here. The proposal would also require companies registering securities to report, to the extent practicable, the approximate amount of assets employed in each segment of business.

For some time the staff has felt that the 15% test of materiality, used in our existing rules, was too high. Certain earlier proposals reflected this view. The F.E.I. study suggested retention of the 15% test. The proposal out for comment would drop the test to 10% of the volume of business or net income before extraordinary items and income taxes and extend the disclosure requirement from one to five years. The response of financial analysts in the F.E.I. study showed that the majority felt that 10% to 14% was a desirable balance between the need for information and the burden on management, and that the maximum number of segments of the business to be reported should be eleven or less. Setting the test at 10% would seem to meet these views. In this regard, we have noted many examples of companies which have voluntarily reported separately on segments that accounted for less than 15% of sales or earnings of the business.

I am aware that the managing director of the F.E.I., in a letter sent to members on September 17, took issue with this and certain other requirements in the proposal as not being in

accord with the recommendations in Dr. Mautz's study. On this same date, our staff conferred with members of the F.E.I. Committee on Corporate Reporting regarding these and other possible areas of disagreement. The reasons for the position taken in the proposal were explained and it was thought that there was an understanding of them by your committee. Your committee very recently submitted further comments reflecting its viewpoint. I should note also that others, outside the Commission, interested in this problem have not agreed with certain of the conclusions of the F.E.I. study. We will, of course, give very serious consideration to the comments of your committee and to others who write us concerning the proposed amendments.

I must reiterate that the SEC's interest in this reporting problem is, simply and solely, to secure additional disclosures helpful to investors and their advisers. We have no other motivation. Our experience in the past few years with voluntary disclosure shows that the problems involved in developing improved disclosure can be overcome. Nevertheless, there are some who do not favor additional disclosure. They argue that disclosure of the profitability of the various business lines of a diversified company will place the company at a disadvantage with respect to its customers and competitors. These protests are similar to those which greeted the required disclosure of sales and cost of goods sold when the Securities Acts were adopted and implemented over a generation ago.

To sum up, the need for improved disclosure is clear. The feasibility of improved disclosure has been demonstrated. It has been long delayed, but with the assistance and cooperation of business and professional groups, such as the F.E.I., the Commission hopes that improved disclosure for diversified companies will soon become a reality.

Finally, I believe it important to note that improved disclosure, as I have discussed it thus far, is not the answer to all the reporting problems of diversified companies. We have, to use but one illustration, noted recent instances in which companies, in the narrative sections of their reports and in the news media, have distorted their growth records by comparing current earnings--which included earnings derived from acquisitions and accounted for on a pooling-of-interests basis--with prior year earnings which had not been restated on a pooled basis. This, of course, was inconsistent with Accounting Principles Board Opinion Number 10. In a recent release (Securities Exchange Act Release No. 4910) the Commission indicated that it considered such comparisons misleading within the meaning of the relevant provisions of the Securities Acts. This release also indicated, as did the APB opinion, that if companies wish to reconcile restated figures with those previously reported, this may be done on a supplemental basis.

Although recent Accounting Principles Board accounting opinions have dealt with reporting for business combinations, there is an urgent need for re-examination of the basic criteria established by the profession for determining the applicability of purchase or pooling accounting in a combination. These standards have been seriously eroded over the years. This fact, along with the increased use of more complex securities, and differing methods for dealing with them, have brought about distortions of the pooling concept beyond its original purpose. Questions have arisen whether pooling accounting is used primarily to improve reported earnings figures, rather than to reflect the economic nature and effects of certain types of combinations. Where applicable accounting rules permit, the astute business manager still can increase a company's reported sales and earnings (if not apparent performance) by adding the sales and

earnings of another company through merger or acquisition. Among the more serious problems flowing from the accelerating trend toward diversification from a disclosure standpoint, is this tendency to distort the pooling concept.

The recently published Accounting Research Study on "Accounting for Goodwill" which also deals with accounting for business combinations may provide further stimulus for the development of new or improved standards in this area of accounting. It has evoked extensive comments from all members of the Project Advisory Committee. We hope to assist, by our comments, in the development of appropriate standards.

If you have followed our recent activities you know that we are not really looking for business. We have enough to keep us busy for some time. It is also a measure of the importance with which we view these reporting matters that we take so much time at this juncture, to deal with them. Many think we are taking too much time. While I believe that our sense of priorities here is sound, it should not be interpreted as a reflection of a lack of urgency or importance of a reasonably prompt solution of these problems.