AN ASSESSMENT OF THE CONGLOMERATE IDEA

Some Aspects of Financial Reporting

Comments by

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My assignment for this panel discussion is to present the SEC's point of view on reporting for conglomerate companies.[1/] When the invitation was extended to me the Commission had published a proposal for the amendment of the description of business items in two registration forms under the Securities Act of 1933 and the form for initial registration under the Securities Exchange Act of 1934. This proposal was directed to disclosure of the importance of various lines of business to companies' end results. The need for improvement in this area of financial reporting for the benefit of investors had been a subject for active public discussion for over two years, some of it clearly inspired by speeches made by Chairman Cohen. The release announcing the proposal stated that consideration of comparable amendments to other disclosure requirements was deferred pending completion of the study of disclosure under the Securities Exchange Act of 1934 being made by the Commission under Commissioner Wheat's supervision. This embraces annual and interim reports to the Commission, as well as possible amendments of the rules relating to the content of corporate reports to stockholders.

In some of the comments received we were urged not to adopt the amendments at this time in order to permit corporations a reasonable time to provide extended reporting on a voluntary basis. This is exactly what has been done by postponing rulemaking in the areas mentioned even though we have been talking about it and urging voluntary disclosure for several years and so have the American Institute of Certified Public Accountants, National Association of Accountants, and the Financial Executives Institute. In any event, the voluntary treatment does not seem to be the way to accomplish the desired results in prospectuses and initial registrations with the Commission.

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.

The proposal calls for disclosure on several matters not covered by existing instructions in the description of business items in the forms but which have been disclosed in one way or another in response to common administrative or financial reporting practices. Considerable objection was raised to what appeared to be an extension of the requirements to include foreign operations, government business and single customers. We think these problems can be resolved. These are side issues and are not pertinent to our discussion today. The significant remaining points for us are the definition of a segment of a business and the size test.

As to size, our present rule uses 15% of volume of business as the test for disclosure regarding the relative importance of products and services or class of products and services. The FEI study, with which you must be familiar, suggested retention of this test, but we proposed dropping it to 10% of volume of business or net income before extraordinary items and income taxes. For some time we have felt that the 15% test was too high here and in some other rules. The financial analysts who responded in the FEI study seemed to support our view since the majority indicated that 10% to 14% was the desirable measure and that the maximum number of segments of the business to be reported should be 11 or less. While substantially all of the individual corporation comments on this point in the responses to our proposal were opposed to the reduction from 15% to 10%, only about one half of the letters from this source covered this subject. However, a review of reports to stockholders reveals voluntary disclosure on segments of the business which are less than 10%. We must assume that such disclosure of distinct lines of business reflects management's judgment as to meaningful reporting. In some cases very little disclosure of this nature would be made under a 15% test.

The many questions raised regarding our proposed definition of a segment of the business indicates that we have not communicated clearly what was intended. The rule now in the forms refers to the production or distribution of different kinds of products or the rendering of different kinds of services and, as noted, requires a disclosure of the relative importance of each product or service or class of similar products or services which contributed 15% or more to the volume of business. Our proposed amendment eliminates the reference to <u>each</u> product or service and instead uses a broader term, each class of related or similar products or services. We thought this terminology, when considered with the criteria from the FEI study for their segmentation which we incorporated into the rule, caught the spirit of the recommendations in that study while retaining language familiar to practitioners before the Commission. In the discussion in the release of the proposed changes we referred to registrants engaged in different lines of business. The FEI study speaks of broad industry groupings, and the sponsors feel that we have disregarded their suggestion in this respect. It is clear that an understanding must be reached here in order to obtain meaningful responses to the rule.

Although the problems of reporting upon a diversified business have stirred up considerable public discussion, it is obvious from the composition of this panel that other accounting and reporting problems require comment. It is not my function to discuss the propriety or legality of the growth of business enterprises into what are commonly referred to as conglomerates. Nor is it appropriate for me to discuss the capacity of corporate officers to manage such aggregations of diverse business operations. Others on the panel must be here, in part at least, for these purposes.

It may be noted here that in Forbes' 21st Annual Report on American Industry the companies which we are discussing today are referred to as multi-companies subdivided as conglomerate, agglomerate and in-between. All, Forbes says, have little in common except for their diversity.[2/] So it seems that the title Financial Reporting by Diversified Companies given to the FEI study was a good choice since it covers all categories. An associate of one of our panelists, in discussing an aspect of our general subject, defined "horizontal" and "vertical" mergers and says the remainder are conglomerates.[3/]

The rapid growth of corporations through the acquisition route, particularly by the exchange of securities, has created important accounting and reporting problems. The history of the concept of a pooling of interests and the bases for distinguishing a pooling from a purchase have been recited many times. The relative merits have been debated vigorously for about the last twenty years.

Recurring problems arise today in determining whether pooling or purchase accounting is appropriate in a business combination. The Commission has dealt with the questions on a case-by-case basis, using as a reference the criteria set forth in ARB No. 48, "Business Combinations," which was issued in 1957. The serious judgmental area is the provision that no one factor is controlling, which means that if some factor lends strong support for a pooling solution weaknesses in others may be disregarded. Each case

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2/ Forbes, January 1, 1969, p. 77.

3/ Joel Davidson, "Conglomerate Concentration and Section Seven: The Limitations of the Anti-Merger Act," Columbia Law Review, November 1968.

where pooling accounting is desired is argued as being substantially the same as other identifiable cases which are deemed to be precedents--any difference is claimed to be immaterial. As a result, the staff of the Commission and representatives of registrants and their accountants have had to reach a workable interpretation of the criteria in each case, but this has led to serious erosion over the years.

My experience in writing about this problem is that a statement of current policy seems to be obsolete before the paper gets into print. We agree with those who believe that the situation has now reached a point where, because of the serious erosion of the standards, as well as the introduction of new types of securities, the changing climate for mergers, and other economic factors, a serious reexamination of the prevailing practices in this area of accounting must be made.

Last October the long-awaited Accounting Research Study No. 10 was released by the Institute. "Accounting for Goodwill" by George R. Catlett and Norman O. Olsen is sure to command attention. This work was authorized to serve as a necessary companion to ARS No. 5, "A Critical Study of Accounting for Business Combinations," by Arthur R. Wyatt.

Messrs. Catlett and Olsen have reached the conclusion in their study that the accountants have failed to hold the line and they have endorsed Wyatt's conclusions that, except for rare cases in which they consider a new enterprise has been created, the proper accounting for business combinations is found in the general concepts underlying purchase accounting and that pooling-of-interests accounting is not a valid method. This conclusion leads them to the problem of accounting for goodwill which may arise in a

purchase transaction and they conclude that the goodwill should not be set up as an asset and amortized by charges to income but should be accounted for as a reduction in stockholders' equity at the time of the combination.

I have observed that there is considerable misunderstanding in financial and legal circles as to the present requirements for accounting for goodwill. It is often stated that purchase accounting is not desirable when there is an excess of the purchase price over the underlying equity acquired, as this debit excess must be amortized. While there is respectable support for amortization, the applicable rules[4] in effect today do not require amortization of this intangible unless it is deemed to have a limited life. Most managements represent just the contrary--no plan of amortization has been adopted because no diminution of value of the intangible is foreseen. Occasionally we find a situation in which the value attributed to the stock issued in exchange is less than the underlying equity acquired as shown on the acquired company's books. In this situation we have objected to purchase accounting when the criteria for the pooling treatment are present to avoid the creation of a credit excess which under current rules[5] must be amortized. There is an inconsistency in the Institute's Accounting Research Bulletins under which amortization of a debit excess is optional but amoritzation of a credit excess is required. This needs correction.

It is significant that all members of the Project Advisory Committee for the goodwill study commented on it. One member, a partner of the

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4/ Chapter 5, Accounting Research Bulletin No. 43, and Accounting Series Release No. 50.

5/ Accounting Research Bulletin No. 51.

authors of the two studies, recommends that the Board issue an opinion as soon as possible adopting the conclusions of the study. Another member believes the AICPA should not attempt to solve this problem alone but should organize an advisory council such as was formed by the FEI to assist on its study, Financial Reporting by Diversified Companies. (Publication of the study, of course, is intended to elicit comment from all interested parties.) The other five members of the advisory committee agreed in part and disagreed in part, some in sharply worded comments.

Some members of the committee suggest that there is a place for the pooling-of-interests concept but the criteria need reexamination. Others disagree on the recommended accounting for goodwill under the purchase approach. Some believe that immediate write-off of goodwill is inconsistent with the purchase concept and that amortization should be required. It is obvious that the subject must have our serious attention.

It is our practice to comment on the research studies and the APB opinions which may or may not adopt the conclusions of the studies. Copies of the study have been made available to all of the Commissioners and to the accountants on the staff. It is too early to predict what the solution to this problem will be, but a solution is urgently needed as every day seems to bring a new variant in this difficult area of accounting.

In the meantime most business combinations are brought within the pooling concept. Reporting for the continuing enterprise then becomes a problem. The concept of a pooling is that formerly separate businesses combine and continue to operate as though they had always been one enterprise. It follows that after a pooling the prior years' results must be combined

for a proper comparison with the current and subsequent years. This procedure is required under APB Opinion No. 10.

The Commission supported this method of reporting in Securities Act of 1933 Release No. 4910. The Commission observed in this release that "where a 'pooling of interest' has occurred, companies may wish to reconcile 'restated' sales and net income figures with those previously reported. This may be done by presenting, in addition to restated income statements, separate statements of income for the same periods on a historical basis, i.e., 'as previously stated,' or by breaking down the sales and net income figures in the restated income statement for each period to show the amounts attributable in that period to the pooled companies." This latter device is being requested in summaries of earnings in material filed with the Commission.

One aspect of the current merger situation warrants a final comment. Some acquisition-minded managements have so many irons in the fire at one time that it is almost impossible for them to prepare proxy material or registration statements on a timely basis that meet the requirements for certified financial statements. Under the Securities Acts or our rules certified statements are required for both parties in an exchange offer and also in a cash purchase transaction if the proceeds of the offering are to be used to effect the purchase, or if other funds are used and the acquisition is material.[6/] Failure to observe these requirements in time can be the cause of serious disruption of time tables.

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6/ See paragraph 27 of Schedule A, Securities Act of 1933 and Instructions as to Financial Statements of Form S-1.