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# SEC "LINE OF BUSINESS" REPORTING REQUIREMENTS

A. A. SOMMER, JR.\*

Among the most intense pressures created by the current (or perhaps "recently past" is a more correct appellation in view of the activities of Congress, the Antitrust Division of the Justice Department, the American Institute of Certified Public Accountants and others) wave of mergers has been the demand for some manner of reporting the profitability of segments of enterprises. Considering the long struggle to gain uniform acceptance of consolidated statements (a process completed perhaps only in the *Atlantic Research* matter),<sup>1</sup> this new move toward fragmentation may be startling to many. The demand has come from many sources. First, the antitrust militants insisted that current reporting practices obscured information desirable for two purposes: one, to facilitate enforcement of antitrust laws by exposing anticompetitive practices, e.g., predatory pricing in one segment supported by monopolistic prices in another; and two, to encourage competition attracted by the knowledge that inordinate profits were being realized by a segment of a diversified enterprise.<sup>2</sup> The investment community took up the cry and asserted that in many instances the absence of such information prevented effective analysis of a company's historical earnings and future prospects.<sup>3</sup> In the wake of these powerful voices, the Securities and Exchange Commission, after careful study, did something about the problem, though not enough to quiet the cries of the antitrust advocates and the investment analysts.

Arrayed against these advocates have been powerful segments of the

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<sup>1</sup> *In re Atlantic Research Corp.*, SEC Securities Act Release No. 4657 (Dec. 6, 1963). In this matter, the registrant had had the practice in its annual reports of including only financial reports of the parent, instead of fully consolidated statements which would have reflected the losses of certain subsidiaries. As a consequence of this case, the Securities and Exchange Commission amended rule 14a-3 under the Securities Exchange Act of 1934 to require the inclusion of consolidated statements in annual reports and that either the principles of consolidation or other accounting principles and practices, or methods of applying accounting principles and practices, used in preparing the financial statements contained in filings with the Commission, principally Form 10-K, and those contained in annual reports correspond, or any differences be noted and the effect thereof reconciled or explained.

<sup>2</sup> *Hearings Pursuant to S. Res. 40 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess., pt. 5, at 1877-78 (1966) (testimony of Dr. Willard F. Mueller, then Director, Bureau of Economics, Federal Trade Commission) [hereinafter cited as *Concentration Hearings*]; Blair, *Antitrust Implications of Conglomerate Reporting*, in *PUBLIC REPORTING BY CONGLOMERATES* 25 (A. Rappaport, P. Firmin & S. Zeff eds. 1968).

<sup>3</sup> *Concentration Hearings*, pt. 4, at 1705 (testimony of Yura Arkus-Duntov, an investment officer of the Dreyfus Fund).

business community,<sup>4</sup> although an increasing number of companies which might be called "conglomerates" have divulged more and more information concerning the results of operations of their segments.<sup>5</sup> Nonetheless, the complaints from the business community concerning the proposals for segmented reporting have been loud and plaintive — and continuing.<sup>6</sup>

The opposition of the business community has largely been along the following lines:

(1) Disclosure of segmented profitability will benefit competitors by providing them with useful information, which can be used to the detriment of the shareholders of the reporting corporation in connection with pricing policies and the like.

(2) Such disclosure will injure the reporting company which is realizing a high profit in one unit by arming its customers with information which they will use to drive prices — and profits — down.

(3) Such disclosure will give a powerful bargaining tool to unions in units which are realizing high profitability.

(4) Such disclosure will discourage innovation, experimentation and the commitment of capital for new developments, since management will fear shareholder criticism for utilizing the resources of the enterprise in losing activities, particularly if they are somewhat prolonged before becoming profitable.

(5) Such disclosure would not, because of diversities inherent in businesses, varying practices for allocating administrative and other central costs, and intracorporate transfers, provide any meaningful information to investors.

The recent proposals for conglomerate disclosure did not arrive on the scene without antecedents. The April 1945 issue of the *Journal of Accountancy* contained a persuasive plea by William H. Moore for reporting the profitability of divisions.<sup>7</sup> Further, for many years the Commission has required that in the Form S-1 description of the registrant's business, any product or service or class of products or services which contributed more than 15 percent to the gross volume of business must be identified and its "relative importance" to the registrant stated. Ordinarily, the Commission staff, in enforcing this requirement, has simply required a statement of the sales of component products or services, although it is evident that under the language quoted it also could have required some statement of profitability. It has, in fact, not been uncommon in recent years for the staff of the Commission to ask a registrant to state whether the relative contribution

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<sup>4</sup> MACHINERY AND ALLIED PRODUCTS INSTITUTE, TOP MANAGEMENT LOOKS AT PRODUCT-LINE REPORTING (1967).

<sup>5</sup> Hobgood, *Voluntary Disclosure in 1968 Annual Reports*, FINANCIAL EXECUTIVE, Aug. 1969, at 64.

<sup>6</sup> *Profit Breakdown Rule Alarms Some Concerns; SEC Dismisses Fears*, Wall Street Journal, Nov. 5, 1969, at 1, col. 6.

<sup>7</sup> Reproduced in *Concentration Hearings*, pt. 5, at 2143 *et seq.*

of each identified product or group of products to profitability was substantially the same as its relative contribution to sales, and if not, whether it was less or greater:<sup>8</sup> "Under the mentioned requirements . . . we seek appropriate disclosures where the contribution of a line of products or services to sales and revenues is not proportionate to the contribution to earnings by the line of products and services."<sup>9</sup>

In 1964 the scene began to change. Senator Philip A. Hart's Senate Subcommittee on Antitrust and Monopoly held hearings on industrial concentration, at which witnesses testified that it had become increasingly difficult to determine the extent of concentration because conglomerate companies did not disclose the sales of their components. In addition, Dr. George E. Brandow, former Executive Director of the National Commission on Food Marketing, expressed concern that conglomerate enterprises might be engaging in anticompetitive activity by subsidizing price-cutting in one area with excessively high prices in another.<sup>10</sup> Whether conglomerates were in fact engaging in such activity, he said, was impossible to ascertain from an examination of their unsegmented financial statements.

In its search for data, the Subcommittee turned to the Commission. Chairman Manuel F. Cohen submitted a memorandum stating that, in the opinion of the Commission staff, the Commission possessed sufficient power to require the disclosures apparently desired by the Subcommittee, but that, in its estimation, it would be unwise to do so. The memorandum set forth well the arguments against segmented reporting — including competitive dangers and the difficulty of allocating common administrative and overhead items — which have since become familiar.<sup>11</sup>

But after submitting this memorandum, and perhaps stimulated by the Subcommittee to reexamine its position, the Commission reversed itself, suggesting that there were, in fact, deficiencies in its disclosure requirements and stating that it proposed to correct them.<sup>12</sup> However, the Chairman made it abundantly clear that his concern was not with the development of additional disclosure to assist antitrust enforcement but was only to aid intelligent investing.<sup>13</sup>

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<sup>8</sup> An example of the manner in which this disclosure often appeared is in the following:

During the foregoing periods, generally the \_\_\_\_\_ group, the \_\_\_\_\_ group and the \_\_\_\_\_ group contributed to the Company's pro forma profits in substantially the same proportions as their contributions to aggregate pro forma sales; the \_\_\_\_\_ group and the \_\_\_\_\_ group contributed less proportionately to profits than to sales; and the \_\_\_\_\_ group contributed proportionately more to profits than to sales.

<sup>9</sup> Memorandum prepared by Office of Chief Accountant and Division of Corporation Finance, Securities and Exchange Commission, with respect to a letter from Senator Gaylord Nelson to Chairman Hamer Budge, June 20, 1969.

<sup>10</sup> *Concentration Hearings*, at pt. 5, 1960-62.

<sup>11</sup> *Id.* at pt. 2, 1069 *et seq.*

<sup>12</sup> *Id.* at pt. 5, 1981 *et seq.* (testimony of Manuel F. Cohen, Chairman, Securities and Exchange Commission).

<sup>13</sup> *Id.* at 1991.

## THE MAUTZ STUDY

The Commission's change of position generated greatly increased interest in the subject. A committee of the American Institute of Certified Public Accountants investigated the problem, pointed out some difficulties, urged voluntarily expanded segment disclosure, and argued strongly that, in the event such disclosures were required, they should not be within the responsibility of accountants.<sup>14</sup> The security analysts pressed for more disclosure.<sup>15</sup> The Financial Executives Institute, an organization of corporate financial executives, sponsored an in-depth study of the problem; under Robert K. Mautz, Professor of Accountancy at the University of Illinois, the Institute's Research Foundation embarked on a study that took a year and a half, and produced an extensive research report and a series of recommendations.<sup>16</sup>

In its published notice of proposed requirements, the Commission stated that it had considered the Mautz Study, as well as the publications and suggestions of others. In many respects the Commission seems to have followed the Mautz recommendations. In others, it has set more stringent requirements.

The Mautz Study reached these conclusions:<sup>17</sup>

(1) Only companies which operate in more than one "broadly-defined industry" should be required to "fractionalize themselves for reporting purposes."

a. To be subject to segmented reporting a company must have two or more components which (1) operate in different industries, broadly-defined; (2) experience rates of profitability, degrees of risk or opportunities for growth independent of other components; and (3) meet the test of materiality (see below).

b. Companies whose segments transfer substantial amounts of products to, or receive substantial amounts of products from, other segments with which they are integrated in a product sense should be considered unitary in nature.

(2) A company operates in more than one broadly-defined industry when it receives gross revenue from, derives income from, or utilizes assets

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<sup>14</sup> AICPA, *Disclosure of Supplemental Financial Information by Diversified Companies*, APB OP. No. 9 (1967).

<sup>15</sup> McCallan, *A View From the Investment Community*, in *PUBLIC REPORTING BY CONGLOMERATES* 47 (A. Rappaport, P. Firmin & S. Zeff eds. 1968).

<sup>16</sup> R. MAUTZ, *FINANCIAL REPORTING BY DIVERSIFIED COMPANIES* (1968).

<sup>17</sup> *Id.* at 157-58. It is interesting to note that the Mautz Study utilizes "rates of profitability, degrees of risk or opportunities for growth" in two contexts: in one context these are used to define a component, and in the second context they are used to define a "broadly-defined industry." Thus, it would appear that for it to be required that a component be reported upon separately it must operate in an industry that is "subject to significantly different rates of profitability, diverse degrees of risk, or varying opportunities for growth" as compared with the industries in which other components operate and, in addition, the component itself must "experience rates of profitability, degrees of risk or opportunities for growth independent of other components. . . ."

in industries subject to significantly different rates of profitability, diverse degrees of risk, and varying opportunities for growth. All mechanical methods of segmenting companies (*e.g.*, the Standard Industrial Classification) were rejected in favor of leaving to management the responsibility of segmenting the company.

(3) The test of materiality referred to above would be met if a component in a broadly-defined industry accounted for 15 percent or more of the company's gross revenues, provided, however, that if this figure was disproportionate to the income of, or assets used in, the segment, then "a more representative test of the materiality of the diversification should be used."

(4) With respect to each segment thus identified and meeting the materiality test, gross revenues and profitability would have to be disclosed, the latter either before or after allocation of common or corporate costs "relative contribution . . . to income." Appropriate disclosure should, of course, be made concerning the course followed.

(5) If the method of pricing intracompany transfers or allocating common or corporate costs significantly affects the reported contribution to income of the segments, the methods used should be disclosed.

(6) The segmented information should be included in the annual report, but not in the financial statements.

(7) If management "sincerely" believes that the disclosures would have an adverse effect on the interests of shareholders, such disclosure should be made in lieu of the financial disclosures.

More than three years after Chairman Cohen publicly supported for the first time expanded "conglomerate disclosure," the Commission adopted a proposal requiring segmented profitability disclosure by diversified enterprises.<sup>18</sup> The requirements finally adopted reflected modifications responsive to a number of criticisms levelled at two earlier published proposals,<sup>19</sup> although many criticized aspects of the proposals have remained substantially unchanged.

The new requirements apply only to registration Forms S-1, S-7 and 10. The first two forms pertain to public distributions of securities; the last is the form often used to register securities under the Securities Exchange Act of 1934 when they become listed or subject to section 12(g).<sup>20</sup> Thus, there is at the time of preparation of this article no requirement for segmented disclosure of profitability in periodic reporting (*e.g.*, Form 10-K), in proxy statements, or in other filings with the Commission, although as discussed below a pending proposal would expand the requirements. In the affected

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<sup>18</sup> SEC Securities Act Release No. 4988 (July 14, 1969).

<sup>19</sup> SEC Securities Act Release No. 4949 (Feb. 18, 1969); SEC Securities Act Release No. 4922 (Sept. 4, 1968).

<sup>20</sup> Section 12(g) of the Securities Exchange Act of 1934 requires registration under that Act of companies whose securities are traded over-the-counter, and which have 500 shareholders and assets of at least \$1 million. 15 U.S.C. § 781(g) (Supp. IV 1969).

forms, the new requirements have become part of the description of the company's business.

#### "LINE OF BUSINESS"

The starting point in the Commission's requirements is "line of business." The new requirements compel a company which is engaged in more than one "line of business" to make disclosures in addition to those heretofore required with regard to sales and revenues. It will be recalled that the basis of segmentation proposed by Mautz was components engaged in broadly-defined industries.

What then is a "line of business"? There is no definition in the new requirements, although the Commission indicated the criteria adopted by the Mautz Study to identify *distinct industries and components* — varying rates of profitability, opportunities for growth, and degrees of risk — should be used to help group products or services as *lines of business*; the Commission rules require that the basis for the grouping should be "briefly described." It may be that delineation of lines of business by means of these concepts may be considerably more difficult than identifying "broadly defined" industries. The Commission dismissed suggestions that it seek to define "lines of business" with greater precision by indicating in its release that management was in the best position to do this because of the very nature of American business:

[I]n 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 and responsive to its organizational concepts.<sup>21</sup>

This, of course, parallels the approach recommended by Mautz.

If a company has more than one line of business, it must report the revenues and the profitability of each. The basic reporting may be in terms of dollars or percentages; net income is to be stated before income taxes and extraordinary items. If allocation of common costs or the pricing of intra-corporate transfers materially affects the contribution of a line to net income, then the methods of allocating common costs and of pricing intra-corporate transfers, and material changes in these methods between periods and the effect thereof, should be disclosed. The new rules do recognize that in some instances it may be extremely difficult for a corporation to report upon a line of business in the required manner. In such cases, the company

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<sup>21</sup> SEC Securities Act Release No. 4988 (July 14, 1969).

may state the contribution to results of operations "most closely approaching such [net] income" and explain why it is not practicable to state contribution to net income or loss.

Not every "line of business" is required to be separately reported. Corporations which have had sales and revenues in excess of \$50 million during either of the last two fiscal years must make separate disclosure with respect to any line of business accounting for 10 percent or more of sales and revenues or income before taxes and extraordinary items during any one of the two preceding years; the breakpoint is 15 percent for companies with sales and revenues of \$50 million or less. In determining whether the 10 percent or 15 percent standard is met with respect to profit contribution, the profits of all lines of business that made profits are added and no allowance is made for losses.

The rules also require that any line of business which has had a loss during either of the two preceding fiscal years equal to 10 percent or more (15 percent or more for the \$50 million and under business) of the total profits of the profit-making lines of business must be reported upon. Thus, if a corporation had lines of business with profits of \$1, \$2, and \$3 million, and a fourth with a loss of \$7 million, all segments would have to be reported upon even though the corporation as a whole showed a \$1 million loss, inasmuch as each of the segments accounted for more than 10 percent of the profit disregarding the loss of the \$7 million, which in turn would be more than 10 percent (or 15 percent if applicable) of the \$6 million aggregate profits of the other lines. In any event, if the number of lines of business which would have to be reported upon as a consequence of applying these rules exceeds 10, segmented reporting is required only with respect to the 10 lines "deemed most important to an understanding of the business."

The requirement of reporting 10 percent segments in large companies has been criticized as being inconsistent with other requirements which focused on 15 percent and also as perhaps leading to unrealistic fragmentation, particularly in years when profits may be depressed. For instance, for a year when a large company had profits of, say, \$1 million, a very small segment with \$100,000 profits would have to report separately.

The periods to be covered by the line of business reporting are (i) the fiscal years since the commencement of the business, (ii) the last five fiscal years, or (iii) the fiscal years ending after December 31, 1966, whichever are less. There is no requirement for line of business reporting for interim periods. These provisions were intended to meet the criticism that many companies would find it very difficult to reach back a significant period of time to reconstruct the required information.

#### PRODUCT LINES

The new rules have not completely superseded the previous requirements of Forms S-1, S-7 and 10 with respect to the reporting of *the relative*



importance of each product or service or class of similar products or services which contributed 15 percent or more to the gross volume of business done during the last fiscal year. The old rule has generally been interpreted as requiring at least a statement of the sales and revenues derived from such different products or services and perhaps some indication of comparative profitability.<sup>22</sup> The new provisions of the Forms require disclosure for the periods for which line of business reporting is required of the *amount or percentage* of total sales and revenues contributed by each class of similar products or services which contributed *10 percent or more* to total sales and revenues in either of the last two fiscal years (15 percent or more if the total sales and revenues did not exceed \$50 million in either of such years). Thus, a "unitary" company engaged in a single "line of business," but nonetheless having different classes of similar products or services, is required to disclose sales and revenues from the various products or services but not the profitability. That profitability disclosure is not, contrary to the concern of some, required for products or services or classes of them is clearly indicated in the Commission release which finalized the rules:

It should also be noted that to the extent such classification is not coincident with the company's determination of its lines of business or where the company is not engaged in more than one line of business, disclosure is limited to proportion of sales and revenues and *does not require a showing of contribution to earnings.*<sup>23</sup>

In many instances a company's classes of similar products or services will be the same as its lines of business; the new provisions expressly recognize this and indicate that disclosures with respect to product line revenue and line of business profitability may be combined. This provision makes clear that "classes of similar products and services" are not the same as "lines of business"; in other words, it is not "product line reporting" that is demanded by the new disclosures.

Perhaps of more significance than the exact terms of the new requirements will be the manner in which the Securities and Exchange Commission staff interprets and applies them. If the staff genuinely accepts the attitude expressed in the new Release, to the effect that management is in the best position to determine the lines of business in which its enterprise is engaged, compliance may not be as difficult as many have anticipated. On the other hand, if it appears that managements take advantage of the latitude afforded them for the purpose of avoiding meaningful disclosure (one such means would be by asserting that the company had many, many lines of business, none of which accounted for 10 percent [or, where appropriate, 15 percent] of gross revenues or profits), then it is likely that the Commission will adopt more exacting standards for determining lines of business.

Thus far, the administration of these rules by the Commission staff appears to have been light-handed. For instance, Monsanto Company,

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<sup>22</sup> *Supra* at pp. 927-28.

<sup>23</sup> SEC Securities Act Release No. 4988 (July 14, 1969) (emphasis added).

with profits of over \$100 million, and which described itself in its preliminary prospectus as "an integrated chemical company engaged in the manufacture and sale of a widely-diversified line of products derived primarily from petroleum and natural gas" and stated that "the conversion of basic chemicals, plastics and fibers into finished products is becoming a more important part of Monsanto's business," succeeded in convincing the staff that it was truly unitary and that it should not be compelled to report separately with respect to fibers and plastics, largely because of their intimate interweaving with chemicals.<sup>24</sup>

#### SPECIAL SOURCES OF REVENUE

Among the most controversial portions of the initial Commission proposal were the requirements that where 10 percent or more of total sales and revenues or net income was derived from overseas operations, from government procurement, or from a single customer, information with regard to revenues and profitability from such sources would have to be separately reported. The torrent of criticism which met this proposal blunted, but did not defeat, the Commission's attack on these problems.<sup>25</sup>

#### *Single Customers*

With respect to the disclosure of business done with a single customer, or a very few customers, the new provisions simply adopt a portion of the "Guides for Preparation and Filing of Registration Statements" (Guides),<sup>26</sup> Item 27 of those Guides and the corresponding provision of the amendments to Forms S-1, S-7 and 10 require that

[i]f a substantial part [the new requirements refer to "a material part"] of the business of the registrant [the new requirements add "and its subsidiaries"] is dependent upon a single customer, or a very few customers, the loss of any one of which would have a materially adverse effect on the registrant, the name of the customer or customers and other material

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<sup>24</sup> This statement appeared in the preliminary prospectus dated September 4, 1969 of Monsanto Company:

With the exception of certain product lines representing in each case less than 10% of total net sales and total net income, Monsanto's chemical business, which the Company regards as a single line of business, is characterized by common raw material sources, interrelation of feedstocks, substantial inter-divisional transfer and considerable dependence of transfer costs on over-all volumes. Although the determination of net income by product groups is necessarily arbitrary because of these factors, it can generally be stated that over the last five years man-made fibers have consistently represented a greater percentage of net income than net sales, while plastics, resins and coatings have represented a lesser percentage of net income than net sales. Products for agriculture have generally contributed a higher percentage of net income than net sales, except for 1968 when net sales were adversely affected by depressed ammonia prices and by prior year herbicide inventory buildups by dealers.

<sup>25</sup> For a summary of criticism received by the Commission in response to the revision of its original release, see BNA, SEC. REG. & L. REP., No. 4, at A-5 *et seq.* (June 25, 1969).

<sup>26</sup> SEC Securities Act Release No. 4936 (Dec. 9, 1968).

facts with respect to their relationship, if any, to the registrant and the importance of the business to the registrant should be included.<sup>27</sup>

Even before the Guides, this information was frequently requested by the Commission staff in connection with registration statements, although it was possible, upon presentation of persuasive reasons, to secure forbearance from the staff with respect to this disclosure. With this matter now formalized by incorporation in the Forms themselves, it is likely to become harder than it was before to dissuade the staff from insisting upon the inclusion of this information.

### *Overseas Operations*

With regard to material operations outside the United States, the new requirements provide that

appropriate disclosure shall be made with respect to the importance of that part of the business to the registrant and the risks attendant thereto. Insofar as practicable, furnish information with respect to volume and relative profitability of such business.<sup>28</sup>

This language represents something of a retreat from the position initially taken by the Commission with regard to overseas operations. It does not include an absolute requirement that net income before taxes and extraordinary items be stated with respect to overseas business; it would appear that something less than full profitability disclosure is sufficient — perhaps something along the order of a statement of the amount of aggregate sales accounted for by overseas business, coupled with a declaration to the effect that such operations were substantially more (or less) profitable than those conducted in the United States.

Many commentators have remarked upon the possibly misleading implications of a disclosure of profitability of overseas operations.<sup>29</sup> Expenses of development are often borne by domestic operations, so that when the product is introduced abroad, the income is free from such expenses. This may, many feel, have unfortunate trade policy results by leading overseas customers to believe they are being charged excessively.

However, it should be remarked that this proposal is not really revolutionary; the accounting profession itself has suggested that assets and liabilities, income and losses, of foreign operations should usually be separately stated.<sup>30</sup>

### *Regulated Business*

Information concerning sales, revenues and income from different classes of products or services in operations regulated by federal, state or

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<sup>27</sup> *Id.*, at No. 17.

<sup>28</sup> SEC Securities Act Release No. 4988 (July 14, 1969).

<sup>29</sup> Letter from Financial Executives Institute to Securities and Exchange Commission, Oct. 14, 1968.

<sup>30</sup> AICPA, *Foreign Operations and Foreign Exchange*, ARB No. 43, at ch. 12 (1965).

municipal authorities can be limited to those classes of products or services required by "any uniform system of accounts prescribed by such authorities." This appears to represent a substantial dilution of the earlier proposal, which would have required disclosure of profitability on government procurement if it amounted to 10 percent of sales or more. It is somewhat difficult to ascertain from these provisions the manner in which the required disclosure should be made or to whom it applies. The provision applies only to "operations regulated by Federal, state or municipal authorities."<sup>31</sup> Is a company engaged in defense contracting "regulated by Federal . . . authorities"? Or rather, does this apply simply to operations such as utilities, railroads, or buslines? What of broker-dealers who are closely regulated by federal and state authorities? This provision, perhaps more than any other, is difficult to decipher and susceptible of varying interpretations.

A very controversial proposal originally put forth by the Commission was the requirement that the assets used in each reported segment be disclosed. This brought forth a flood of criticism and protest, based largely upon the difficulties of making any meaningful allocation of assets among classes of products or services (the initial basis of breakdown) or, as later adopted, lines of business. This provision has now been abandoned, presumably much to the relief of those who found it excessively onerous. However, its exclusion does prevent any analysis of return on investment of the various segments, generally a most meaningful figure.

#### ANNUAL REPORTS

As noted earlier, these new requirements are confined to registration Forms S-1, S-7 and 10. This means that the burden of line of business reporting is placed on a company only when it seeks to distribute securities or when it initially comes under the requirements of the 1934 Act (many companies, *e.g.*, those previously required to file periodic reports, do not have to file a Form 10 when they register securities under the 1934 Act). The proposals deliberately avoided more extensive requirements pending the completion of the Wheat Report. As expected, the Wheat Report<sup>32</sup> strongly recommended that Form 10-K be revised to require an annual reporting with respect to the profitability of segments, and the Commission has proposed a revision of Form 10-K which would adopt reporting requirements similar to those incorporated in Forms S-1, S-7 and 10.<sup>33</sup>

It might be noted in passing that the problem of conglomerate disclosure is not confined to the United States. The London Stock Exchange requires that listed companies report segmented profits. In addition, the British Companies Act of 1967 requires that "if, in the course of a financial year, a company . . . has carried on business of two or more classes . . . that,

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<sup>31</sup> SEC Securities Act Release No. 4936, at 36 (Dec. 9, 1968).

<sup>32</sup> SEC, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 353 (CCH ed. 1969).

<sup>33</sup> SEC Securities Exchange Act Release No. 8682 (Sept. 15, 1969).

in the opinion of the directors, differ substantially from each other," then the "directors' report" (that is, the annual report) must state the sales of the classes and "the extent or approximate extent (expressed, in either case, in monetary terms) to which, in the opinion of the directors, the carrying on of business of that class contributed to, or restricted, the profit or loss of the company for that year before taxation."<sup>34</sup> It is significant that the determination of whether a company has carried on business of two or more classes is left to the judgment of the directors without any criteria stated for making that determination.

#### ANTITRUST IMPLICATIONS

While the present Commission action with respect to conglomerate reporting had its origins not in securities law considerations but rather in antitrust concerns, it is apparent on the face of these requirements that the additional information disclosed will not necessarily be of much assistance to those seeking to appraise the impact of the merger movement. For instance, it will be difficult, if not impossible, from the disclosures now required by the Commission to determine whether a conglomerate is deliberately lowering prices on some products to secure competitive advantage and making up for such reduced profits by increasing prices on other items where competition is less intense. Conclusions concerning the extent of concentration may be facilitated to some extent, but in many instances the meaningful information may be effectively obscured.

The realization that the newly required disclosures will be of limited assistance to those concerned with antitrust matters is evident in Senator Gaylord Nelson's letter to Chairman Budge. In that letter (which is dated June 20, 1969, and was thus written before finalization of the Commission's proposals), after reviewing the history of the Commission proposals, the Senator stated:

Notwithstanding my feeling that the proposed amendment will be of limited utility in ameliorating the competitive information problem that has so long troubled my Subcommittee, I do believe that they are desirable and I regret that they have been delayed for so many months in becoming effective.<sup>35</sup>

The necessity of further profitability disclosure was also adverted to in the *White House Task Force Report on Antitrust Policy*,<sup>36</sup> where it was indicated that additional disclosure with regard to conglomerate firms should be required in the interest of effective antitrust policy, without, however, specifying the particulars of such increased disclosure.

In many respects the new rules do not satisfy the security analysts either.

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<sup>34</sup> Companies Act 1967, ch. 81, § 17, at 1788-89.

<sup>35</sup> Letter from Senator Gaylord Nelson to Chairman Hamer Budge, June 20, 1969.

<sup>36</sup> 1968 PRESIDENTIAL TASK FORCE REPORT ON ANTITRUST POLICY, 115 CONG. REC. 5642 (daily ed. May 27, 1969) [hereinafter cited as NEAL TASK FORCE REPORT].

As mentioned, by eliminating the requirement of disclosure of assets used in the various segments, determination of effectiveness in the utilization of resources in the reporting company's various activities is precluded. Further, by vesting in management such broad discretion in determining lines of business, by rejecting mechanical tests such as the Standard Industrial Classification, and by allowing broad discretion in allocating central costs and pricing intracorporate transfers, comparability of the operations of similar segments of various companies, one of the principal expressed objectives of the analysts in pressing for enhanced disclosure, has been eliminated.

Still, for all their inadequacies in the eyes of interested groups, the new rules will yield substantial additional information; the extent to which it is useful information has yet to be determined.

#### PROBABLE DEVELOPMENTS

It is apparent that the development of conglomerate reporting is far from concluded. It is likely to be continued in three directions:

First, it is almost certain that in the not too distant future (perhaps by the time this paper is published) disclosure of profitability with respect to lines of business will be required by the Commission in its periodic reporting system, as well as when a company proposes to make a distribution of securities or to list securities on an exchange, or becomes subject to section 12(g) of the 1934 Act.

Second, as experience tests the feasibility of the new requirements, it is not unlikely that modifications may be made, some by way of fleshing out ambiguous concepts such as "line of business," others by expansions that will yield more significant aggregating and fragmenting of data for investment purposes.<sup>37</sup>

Third, unsatisfied by the new Commission requirements, those interested in antitrust matters will press hard for additional disclosure. To this end Senator Nelson is apparently in the process of framing legislation to require additional public disclosure of information by conglomerates. It is not unlikely that this legislation will go well beyond the present pattern of disclosure required by the Commission. Chairman Budge has indicated in his response to Senator Nelson that he does not regard a legis-

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<sup>37</sup> An interesting proposed extension of conglomerate reporting is persuasively set forth in A. RAPPAPORT & E. LERNER, *A FRAMEWORK FOR FINANCIAL REPORTING BY DIVERSIFIED COMPANIES* (1969), a research study published by the National Association of Accountants. The authors propose that "Financial Statements should . . . be designed to provide the investor with current earnings arranged in a format which can serve as a basis for estimating growth and future earnings." The authors suggest that earnings of "basic activities" be arranged in a manner that clearly displays the amount of earnings derived from activities with varying rates of growth, that is, the proportion of earnings which is attributable to activities which have experienced a 0 to 5 percent growth rate annually, the amount attributable to activities which have experienced a 5 to 10 percent growth rate, etc.

lative endeavor for antitrust purposes as inconsistent with the work of the Commission in the area of conglomerate disclosure. The extent to which such legislation will seek to make the Securities and Exchange Commission the vehicle for securing this information is uncertain. The report of the White House Task Force on Antitrust Policy would place this additional burden on the Commission:

We recommend that the provisions of the Securities Exchange Act of 1934 authorizing the SEC to specify the details of financial reports "for the protection of investors and to ensure fair dealing" in the securities markets be expanded to recognize the impact of profit and loss information on the operation of competitive markets, and to require that the SEC issue regulations implementing these provisions after consulting with the Justice Department and the Federal Trade Commission.<sup>38</sup>

It is far from certain that burdening the Commission with the responsibility of supplying data for antitrust policy and enforcement is a wise move, for such a course could quickly dilute the time and energy of the Commission when the securities markets demand all there is available.

It is probable that, as happened after the enactment of the Securities Act of 1933, once the new disclosure becomes a way of life, the forebodings and alarms will be forgotten and no one will be seriously harmed. It is heartening that during the course of the controversy, business voices often declared that far from being a curse, conglomerate reporting had affirmative benefits for business.<sup>39</sup> In time perhaps this will become a consensus. Whether it does or not, it is unlikely that the pressures for fuller disclosure can be successfully resisted.

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<sup>38</sup> NEAL TASK FORCE REPORT at 5648.

<sup>39</sup> Hartmann, *A View from Management*, in PUBLIC REPORTING BY CONGLOMERATES 63 (A. Rappaport, P. Firmin & S. Zeff eds. 1968).