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Line-of-Business Reporting: A Legal Basis

*J. V. Baumler**

A CURRENT TOPIC OF CONCERN to the financial accounting community is reporting for segments of a business. If a firm is engaged in several lines of business, as conglomerate enterprises are, should they report the financial results of their activity merely in summary fashion for the firm as a whole, or should financial results for the several lines of business be disclosed as well? If some of the segments of a firm are profitable while others are not, should this fact be disclosed? These questions have been discussed and debated for several years. The current debate seems to have had its origins in the anti-trust field. Former chairman of the Securities and Exchange Commission, Manuel F. Cohen, was the major sponsor of segment financial reporting proposals, and his interest in the topic has been traced back to a 1965 appearance before the Subcommittee on the Anti-Trust and Monopoly of the United States Senate Committee on Judiciary.[1] Thereafter, the SEC moved to implement segmental reporting requirements. In September 1968 the SEC issued its Proposed Rules for Disclosure by Line of Business.[2] The business community reacted rather vigorously and the SEC somewhat modified its requirements.[3] But its final amendments called for disclosure of revenue and income by lines of business on the Form 10-K filed annually with the SEC.[4] This became effective with financial statements filed with the SEC dated December 31, 1970 or thereafter. Form 10-K, although available for public inspection and coyping at the Commission's public reference rooms, is not widely distributed. In a recent action, however, rules 14a-3 and 14c-3 were changed to require that firms, in their annual reports to shareholders, must offer to send shareholders their most recent Form 10-K, and must also disclose within the annual report the actual breakdown of revenues and income that is presented in Form 10-K.[5] Specifically, revenue and income must be disclosed for each line of business which produced 10% (15% for smaller firms) of either before tax revenue or income in either of the last two years. Thus, the SEC has rather quickly moved to answer the questions with which we began, reporting by segment is required for those firms under SEC regulation. While

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[1] Sprouse, *Diversified Views about Diversified Companies,* 7 J. ACCOUNTING RESEARCH 137 (1969).

[2] SEC Exchange Act Release No. 8397 (Sept. 4, 1968).

[3] SEC Exchange Act Release No. 8530 (Feb. 18, 1969).

[4] SEC Exchange Act Release No. 8650 (July 14, 1969).

[5] SEC Exchange Act Release No. 11079 (Oct. 31, 1974).

the SEC has taken the lead in this area, other groups have also been active; namely, the Federal Trade Commission and the Financial Accounting Standards Board, and to a lesser extent the Cost Accounting Standards Board.

The action of the SEC has mooted, for regulated firms, the question of whether or not an obligation existed to report a segmented earnings statement even without administrative regulation. Some had suggested that such an obligation did exist.[6] No matter; the question is now answered affirmatively, such reports must be prepared. One can still consider the stimulating question of why they should be prepared and the pragmatically important question of how they should be prepared. It may be argued that the *why* and *how* questions should have been definitively addressed first, but such are not always the workings of administrative bodies. Obviously, the why question relates to the SEC's concern with full and fair disclosure to investors. Two surveys of investors to determine their perceived need for segmented accounting reports have been conducted,[7] but their results are far less than overwhelming. The accounting literature is only recently beginning to include studies as to the impact of segment reports upon users of financial statements.[8] The only safe conclusions at this time are that although most individuals claim a preference for additional financial information concerning firms in which they invest, the usefulness of segmented reports to supply this information is unclear and further research is warranted.

We are none-the-less left with the thorny question of how best to provide segmented financial reports. The next section of this paper will identify the major problems of implementation. Then attention will be focused upon one of these problems and an examination will be made of its possible resolution on a theory drawn from case law developed in the corporate field.

Problems of Implementation

Problems of implementation have been identified in a number of sources,[9] but are far from being resolved. A fundamental problem concerns the determination of which segments are to be reported upon. Often total corporate activity can be sliced many different ways. Consider the firm producing electronic components and jet engines. Both are sold to industrial customers and the federal government. What are this firm's lines-of-business? Some would identify them with prod-

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[6] A.A. Sommer, Jr., PUBLIC REPORTING BY CONGLOMERATES, at 1-16 (1968).

[7] R. Mautz, FINANCIAL REPORTING BY DIVERSIFIED COMPANIES (1968); M. Backer & W. McFarland, EXTERNAL REPORTING FOR SEGMENTS OF A BUSINESS (1968).

[8] *See, e.g.,* Kinney, *Predicting Earnings: Entity Versus Subentity Data,* 9 J. ACCOUNTING RESEARCH 127 (1971).

[9] *See, e.g.,* Sprouse, *supra* note 1; D. Solomons, DIVISIONAL PERFORMANCE: MEASUREMENT AND CONTROL (1965).

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ucts, others with customers. How about an integrated steel company, is coal transport a separate line-of-business? Consider a TV network, is it in both the businesses of entertainment and education? Identification of the lines of business is less than straightforward for virtually any large-scale complex enterprise. To date, the practice of line-of-business identification has been quite inconsistent. One researcher has concluded that no single basis of classification exists which could be utilized by all diversified firms and that considerable flexibility is required in identification of lines-of-business.[10] It is probably fair to say that the SEC has been inclined to accept whatever categorization the reporting companies decide upon.

Given a definition of the lines-of-business engaged in, the next issue concerns the degree of detail required in reporting the financial performance of these segments. As a minimum the revenues and income of these segments must be reported, but in how much detail can and should costs be reported? Should assets and liabilities be divided between lines-of-business? In practice the approach has generally been an aggregation of cost data and a failure to apportion assets and liabilities. This tactic makes impossible return on investment analysis by line-of-business.

A major conceptual problem is how to apportion the firm's revenues and expenses between segments. It is this problem for which we will seek at least a partial solution out of the legal environment.

Fortunately, for most firms, revenues derived from ultimate sale of goods or services to customers are readily identifiable with a segment. But not so with the allocation of common costs. Nor is the split of revenues and costs clear with regard to transactions between segments. Let's look at a couple of illustrations to highlight the problems. The corporate headquarters for a diversified firm provides support activities for the various divisions. For simplicity, these divisions each are considered separate lines of business. They utilize corporate support activities to various extents. Corporate support activities include a legal department, a research center, a labor relations office and a computer service center. How should the costs of these corporate support activities be apportioned among the divisions? This is a problem that cost accountants have concerned themselves with for decades, and the only answer thus far developed is that costs will be apportioned to the divisions in some reasonable but *arbitrary* fashion. We have considered the simple case where the lines of business are synonomous with the divisions. When lines of business represent some combination of divisional activities, the common costs of corporate support activities would undoubtedly be arbitrarily allocated

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[10] Mautz, *Bases for More Detailed Reporting by Diversified Companies*, FINANCIAL EXECUTIVE, at 52 (1967).

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first to the divisions and then to the lines of business. How are such arbitrary allocations to be made? No satisfactory answer exists. What might the impact of these allocations be? They could determine which lines of business report a profit and which report a loss. Do we really serve the investment community by requiring line-of-business reporting when the end result is merely the product of some arbitrary and unknown cost allocation scheme?

A related problem exists when products are transferred between segments. Segment A buys components from Segment B. In order to prepare financial reports for each segment these components must be priced. By pricing them high, profit can be transferred from Segment A to Segment B. By pricing them low, profit can be transferred the other way. Transfer pricing is a classic accounting problem, but for this purpose no definitive price exists.

The real danger is that by manipulating cost allocations and transfer prices, the reporting firm can produce the line of business profitability measures it desires. Without some mechanism for evaluating these practices, the validity of line-of-business reports must be questioned.

We cannot realistically look to the certified public accountant to quickly remedy this situation. Accounting procedures have been geared to assessing reporting practices of the firm as a whole and measuring income of the total entity, except in one rather notable exception — and this exception has produced considerable litigation and a definitive body of law. We will use this exception to seek a standard, a legal standard, for cost allocations and transfer prices.

Segmented financial reports have long been prepared when the segments are separate legal entities. The analogy we seek is a virtually wholly owned subsidiary, but one in which a minority stockholder interest exists. There are many such corporations, the largest probably being Western Electric, Inc.; the manufacturing and supply arm of the Bell System. It is an integral part of the American Telephone and Telegraph Corporation, but as a "line-of-business" it has been separately reported for years. It must be admitted that some may question the validity of these reports. It has often been charged that too much profit has been associated with this non-price regulated segment of AT&T. Obviously, the transfer price of telephone equipment greatly determines Western Electric profit. But the dealings between interrelated corporations with minority stockholder interests is not strictly the province of corporate management. A standard of law exists.

Establishing a Legal Standard

To facilitate the establishment of a legal standard we will strike an analogy. Assume that in lieu of line of business segments we have a situation involving a conglomerate of corporate entities owned almost totally by the parent corporation-in-chief. Assume further that each of these entities has minority ownership[11] as well as interlocking directorates. When line-of-business reports are prepared we might ask: did the directors properly adhere to their fiduciary duties with respect to factors affecting corporate profit — we will impute full knowledge of cost allocations and transfer prices. Similarly, when goods or services are transferred between the parent and subsidiary corporation in our analogy, we might ask: was the conduct of the common directors in regard to the pricing of goods and services in keeping with their fiduciary obligations to the subsidiary corporation. The standards used is assessing the latter situation should provide the necessary framework for examining the former.

We turn now to the standards of conduct required of the common directors in our analogy.

In interpreting the broad duties of corporate management the courts have focused on management's having acted intra vires,[12] having exercised due care,[13] and having observed the requisite fiduciary duties.[14] It is the effects of the latter upon our situation with which we are concerned. A survey of the case law leaves little doubt that directors are in a fiduciary relationship to the corporation. In the words of a leading case, the director

> owes loyalty and allegiance to the company — a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncomproming.[15]

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[11] In practice a similar situation does occasionally occur. An example might be Ling-Temco-Vought, Inc.

[12] There are two views concerning the liability of directors for loss to their corporation from an ultra vires transaction: 1) absolute liability, *see* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 1021-28, (Rev. vol. 1965); and 2) liability for negligence, *see* Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

[13] Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963); Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940). Several states have imposed a statutory duty. *See, e.g.,* N.Y. BUS. CORP. LAW § 717 (McKinney 1963); PA. STAT. ANN. tit. 15, § 1408 (1967). *See also* Adkins and Janis, *Some Observations on Liabilities of Corporate Directors,* 20 BUS. LAW. 817 (1965) (recent survey of corporation laws indicated ten states with statutes in this area).

[14] Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 411 P.2d 921 (1966) (director's conduct of inducing corporate personnel to join competing corporation found to violate fiduciary duty); Bennett v. Prop, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962) (use of corporate funds to purchase corporate shares for purpose of maintaining control by dominating director and his fellow directors is a breach of fiduciary duty); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939) (corporate officers and directors are not permitted to use their position of trust to further their own interest).

[15] Litwin v. Allen, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940).

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Hence, in a situation where goods and services are transferred between the corporation-in-chief and its subsidiary, and inappropriate prices are accepted by the directors of the subsidiary, the validity of the transaction can be challenged by minority shareholders. Thus we approach the gravamen of our problem, by what standard do we measure director conduct in the context of a transaction between corporations with interlocking directorates.

Early case law in this area was guided by an inflexible rule adopted from the English courts. Under this view transactions between a director and his corporation, and thus by analogy between corporations with common directors, was voidable by the corporation regardless of its fairness.[16] This rule, however, exacerbated the difficulties of major corporations dealing in a modern industrialized society,[17] and had the further effect of imposing a fiduciary obligation on coporate directors equivalent to that of agents or trustees.[18]

As a result, the law underwent a rapid evolution, and today the majority of jurisdictions consider the establishment of "fairness" to the corporation sufficient to validate the transaction where disinterested directors have indicated their approval.[19] In the case of interlocking directorates, this rule has been further liberalized to require merely a showing of fairness; *i.e.*, would an independent corporate fiduciary in an arm's length bargain bind his corporation to such a transaction.[20].

An important aspect of this fairness test concerns the burden of proof. Essentially three views exist. The prevailing view, as enunciated by the U.S. Supreme Court in *Geddes v. Anaconda Copper Mining Co.*,[21] is that the party seeking to uphold the transaction must establish

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[16] The court in Reinhardt v. Owensboro Planing Mill Co., 185 Ky. 600, 603, 215 S.W. 523, 524 (1919) observed that

> [d]irectors are bound to exercise nothing short of the uberrima fides of the civil law. They must not in any degree allow their official conduct to be swayed by their interest or welfare, unless that interest be one they have in the good of the company in common with all of the stockholders.

[17] Alabama Fidelity Mortgage & Bond Co. v. Dubberly, 198 Ala. 545, 73 So. 911 (1916); O'Conner Mining & Mfg. Co. v. Coosa Furnace Co., 95 Ala. 614, 10 So. 290 (1891); Glengary Consol. Mining Co. v. Boehmer, 28 Colo. 1, 62 P. 839 (1900); Fitzgerald v. Fitzgerald & Mallory Constr. Co., 44 Neb. 463, 62 N.W. 899 (1895).

[18] *See generally* Scott, *The Trustee's Duty of Loyalty,* 49 HARV. L. REV. 521 (1936).

[19] *See* N. LATTIN, R. JENNINGS & R. BUXBAUM, CORPORATIONS CASES AND MATERIALS 623 (2d ed. 1968). *See generally* Baumhart, *How Ethical are Business Men?,* 39 HARV. BUS. REV. 16 (1961); Thanhouser, *The Corporate Counsel's Viewpoint,* 17 BUS. LAW. 79 (1961); Wadmond, *Conflicts of Business Interest,* 17 BUS. LAW. 48 (1961).

[20] Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85 (2d Cir. 1955); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944). For a good review of the development of the law in this area see Marsh, *Are Directors Trustees: Conflicts of Interest and Corporate Morality,* 22 BUS. LAW. 35 (1966).

its fairness.[22] A second view requires the party seeking to avoid the transaction to show its unfairness.[23] While the third view provides that the party seeking to avoid the transaction has the burden of producing evidence of unfairness, at which point the burden of going forward shifts to the opposing party to show that the transaction was fair.[24]

Regardless of the burden of proof involved, however, the courts have uniformly held that transactions between corporations with interlocking directorates are to be subjected to close judicial scrutiny in order to determine their fairness.[25] Hence, we see emerging a legal doctrine of fairness relating to the critical accounting decisions which apportion income between two closely related corporations when the interests of minority shareholders are involved.

It is suggested that this same doctrine of fairness be used to test the validity of line-of-business reports. The case law from which this doctrine developed has grown out of factual situations which might

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[22] Pepper v. Litton, 308 U.S. 295, 306 (1939); Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85 (2d Cir. 1955). The *Geddes* Court noted that

> [t]he relationship of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration.

254 U.S. at 599.

[23] Wentz v. Scott, 10 F.2d 426 (6th Cir. 1926) (there exists no presumption that the common directors will deal unfairly, and in the absence of evidence tending to show fraud, there is a presumption of honest action); Frank H. Buck Co. v. Tuxedo Land Co., 109 Cal. App. 453, 293 P. 122 (1930); San Diego, O.T. & P.B.R. Co. v. Pacific Beach Co., 112 Cal. 53, 44 P. 333 (1896); Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E.2d 895 (1937); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).

[24] Mayflower Hotel Stockholders v. Mayflower Hotel Corp., 73 F.Supp. 721 (D.C. 1947), *rev'd,* 173 F.2d 416 (D.C. Cir. 1949). The court noted at 724:

> I do not conceive that the phrase, sometimes somewhat loosely used, that such a contract (between corporations with an interlocking directorate) is presumed to be fraudulent, means that a minority stockholder is authorized to bring suit to set the contract aside merely on the allegation that the parties to the contract have interlocking directors and that the plaintiff is thereupon in a position to call upon the parties to the contract to justify their good faith. I am not aware of any case that holds such an extreme proposition. My view of the law is that what is intended by these expressions is that much less evidence will be required to establish a prime facie case and to shift the burden of proof on the question of fraud than would otherwise be the case, if it appears that interlocking directorates exist, rather than that the plaintiff makes out a prima facie case merely by showing the presence of interlocking directors.

See Ward, *Some Notes on Transactions Involving Interested and Interlocking Directors in Pennsylvania,* 23 TEMPLE L.Q. 107 (1949), wherein the author takes the stand that the final view in reality includes the first two in that often courts are facing facts which show uncontrovertedly that one corporation made an unusual profit at the expense of the other. *See also* Cleary v. Higley, 154 Misc. 158, 277 N.Y.S. 63 (1934), *aff'd,* 246 App. Div. 698 (1934).

[25] Pepper v. Litton, 308 U.S. 295, 306 (1939); Southern Pacific Co. v. Bogert, 250 U.S. 483, 492 (1919). The *Pepper* Court noted:

> Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

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not be readily applicable to firms which must now prepare line-of-business financial statements. But both the law and accountants have long recognized and utilized entity concepts more meaningful than mere legal entities. Consolidated financial statements are obvious examples. A similar fiction should be utilized in this instance.

A line-of-business, however defined, is to be conceptualized as a separate corporation, fully controlled, but with a minority shareholders' interest. By using this device, the doctrine of fairness will be called into play. An important related question, but one beyond the scope of this comment, would be how would the reader of a segmented financial statement know if the standard of fairness had been met. Without really addressing this question, we can speculate as to two possible answers. One would require that the corporation, its officers or directors, must assert in their segmented financial statements that the standard of fairness had been met. Alternatively, it could be attested to by an independent outside professional expert, a role which neither attorneys nor accountants would find foreign to their practice.

Conclusion

Some might seek a more definitive solution to the financial reporting problems discussed. Unfortunately, they probably do not exist. For those who might feel that superior reporting practices should be demanded, it is important to note that firms need not go beyond the procedures suggested. Virtually any firm could create actual corporations which exactly parallel the analogous corporations we have posited. Based on the level of reporting now undertaken it is quite clear that income statements for these new corporate entities would fully satisfy SEC Rule 13a-1, and that the legal fairness standard discussed above would be totally appropriate. It seems unreasonable to ask a firm to do more merely due to the happenstance of organizational form. One should not be prohibited from doing indirectly that which it may do directly. Thus we argue that the legal standard of fairness, although at times ill-defined, represents both the maximum standard which logically should be imposed and the minimum standard we could accept.