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Henry P. Hill

ACCOUNTING OPTIONS AND CONGLOMERATE GROWTH

HENRY P. HILL*

The terms "accounting options" and "conglomerates" seem to acquire a special kind of evil connotation when used together. It is timely to examine the characteristics of the members of this notorious couplet and see if it is possible to explain what it is that has led to an intensive effort to separate the two and thereby render each relatively harmless. We may even arrive at some conclusion as to whether the current effort is properly directed and whether it has a reasonable chance of achieving its goal. Even more to the point, an analysis of this union may lead to a conclusion as to whether achievement of the goal of separation will truly constitute success.

Conglomerates have been accused of taking undue advantage of a number of the devices of the modern business world. Antitrust infringement, mistreatment of minority stockholders and circumvention of the economic laws of the marketplace have all been laid at the door of the modern conglomerate. Whether these charges are true is a proper subject for debate, but in this paper we shall confine ourselves to one issue, one alleged distortion of business practice: the misuse of accounting options "to glamorize their profit performance to exploit speculative behavior in a securities market hungry for 'growth' type companies."[1]

THE NATURE OF ACCOUNTING OPTIONS

Without, for the moment, dealing with conglomerates specifically, let us consider the general subject of accounting options. Are there many available? Are they available in many situations? The answer to both questions is unfortunately and necessarily "yes." If "accounting options" means diverse ways of dealing with ostensibly similar situations, there are many occasions for selection.

For example, in determining how to measure his profit on an article of merchandise sold, should a merchant compare his selling price with (1) the cost of the oldest of the particular item he had in stock on the theory that good inventory management requires putting new stock in the storeroom and old stock on the shelves; (2) the cost of his latest purchase of that particular item on the theory that a place to sell is no good without something to sell and, therefore, to some degree inventory is as fixed as capital assets; or (3) should he consider that all of a particular kind of item are essentially the same and, therefore, the appropriate thing to do is average costs? Even

* Partner, Price Waterhouse & Co., New York.

1 *Hearings on Economic Concentration Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary*, 91st Cong., 1st Sess. (1969) (remarks of Dr. Willard F. Mueller).

though the alternative methods can give widely divergent results, all three are acceptable.

Should a company expense its research costs or should it defer them until the products that flow from the research reach the market? Conservatism dictates exclusion from assets by expensing of anything as intangible as investments in research and development. The desire for determination of true profitability of business activity by matching cost and revenue, on the other hand, leads to deferral of a charge until successful exploitation of the fruits of the research.

Numerous other accounting options exist, and the type of consideration involved in resolving choices having been adequately illustrated, it should be sufficient to refer to some of them briefly. An incomplete list would include:

Arithmetic formulas to calculate depreciation;
Replacement cost versus realizable value, to determine market values in inventory, using the lower of cost or market calculations;
Determination of the lower of cost or market calculations by either an individual item method or an overall method;
The degree to which to provide for income taxes that would be levied on parent companies, if they bring home income from consolidated subsidiaries;
Deferral or expensing of mineral development costs;
Recognition of unrealized gains and losses in long-term investments;
Selection of assumptions in estimating pension expense;
Spreading or flowing through investment credits.

Accounting options arise from either of two conditions. They either reflect different ways of viewing similar situations or they result from the different conceptual bases of the balance sheet and the income statement. Different views usually are verbalized in arithmetic terms and result in simple arithmetic-type formulas, such as "first in-first out," "declining balance," "straight line," etc.

The different conceptual bases of the two primary statements (balance sheet and income) have long been a difficult problem. The balance sheet is billed as a statement of assets and liabilities and ought to be prepared on a conservative basis; that is, doubtful assets should be excluded and estimates of probable liabilities ought to be included. On the other hand, the ideal income statement should match revenue with the costs of producing that revenue even if the costs come long before the revenue. Despite the fact that the profit and loss statement is universally acknowledged to be the more important statement, the conservative approach, *i.e.*, the balance sheet, usually is preferred to the matching approach, *i.e.*, profit and loss, because the latter justifies carrying expenses like research and development as assets. Unfortunately, this profit and loss approach requires a crystal ball of absolute clarity, and in the absence of such a device, the danger of using overly optimistic predictions to cast a statement of income is obvious. Accordingly, accounting ordinarily does not recognize income until it is realized, though it often anticipates unfavorable occurrences.

A type of option available to business management that does not have accounting as its source is the option of "business decision." Some of these are obvious, such as decisions to change advertising levels, to change maintenance levels within limits or to change pay rates. Others are a little more obscure, such as advancing or retarding shipments to change the timing of sales, selection of particular investments to sell on the basis of comparative cost, manufacturing for inventory versus reducing the labor force, or leasing versus buying capital assets.

By now it should be clear that management decisions do indeed influence earnings. This should not be surprising. Accounting was devised for the particular purpose of reporting on management. In any case, any misconception that accounting should, and therefore someday will, be a strictly objective measurement of the true situation without the intrusion of any subjective processes, should be dispelled.

What should also be clear is that conglomerates, being highly diversified business activities, should encounter a high proportion of the situations requiring accounting decisions. It should be equally clear that conglomerates can be expected to have highly sophisticated professional-type managements who will make sophisticated use of accounting options. A careful reading of annual reports of some of the well-known conglomerates will show clever use of accounting options and of business options.

But at some point in the ethical scale, use to achieve a purpose becomes misuse. The essence of the accounting charge against conglomerates is that they have misused accounting options to distort reported results. What should be examined, therefore, is which options have been so misused and whether these constitute a peculiarity of conglomerates.

The two abuses of accounting most often attributed to conglomerates are "instant earnings" and "funny money." In addition to having acquired disparaging nicknames, these two objects of reform have something else in common — they arise through the merger process. Since merger activity and conglomerates have a high correlation, these abuses have come to be associated with conglomerates even though there is no conceptual reason for this association.

"Instant earnings" is the process of making use of the lack of compatibility of balance sheet and profit and loss statements. Instant earnings are achieved by selling off all at once assets whose carrying value, presumably cost, is lower than realizable current value. In the conglomerate case, the instant earnings charge arises when the cost is that of a component company merged into the group, and the realization occurs after the merger, thus resulting in the recording of earnings for the entire group. The assets often are investment securities, but they don't have to be. For example, they can be motion picture film libraries with rerun values; they can be operating real estate with a low depreciated value; or they can be real property acquired for its natural resource value that has become more valuable for other purposes. Any asset which is accounted for under the conservative rules of accounting that forbid recognition of unrealized gains is a target for a new management to convert into instant earnings.

"Funny money" is a company's own equity security used as consideration for a merger. The issuing company can manufacture such money almost without cost. To the receiver, however, it has value. Thus, so goes the accusation, mergers accomplished through the issuance of equity securities tend to be overpaid for, without proper accounting to the prior holders of equity securities.

The accounting device that makes both these practices possible is the pooling of interest. Technically precise definitions of poolings are plentiful, but for the sake of this discussion, the following will suffice. A pooling of interest is a method of accounting for a combination of businesses which provides continuous accounting for all the components. The opposite of poolings is purchase accounting, which assumes that one business has been sold, and, as is the case with any sale, it is the new cost, not the seller's original cost, that has to be accounted for.

Thus, in a pooling of interests, equity securities with a market value far in excess of the value of the acquired business can be issued, and only the book value of the selling company will be taken into the combination. If the selling company has conservatively recorded long-term assets, the only thing necessary to produce instant profits for the combined enterprise is to sell the assets and realize unrecorded profits.

Since pooling is the common denominator of the most flagrant of accounting abuses, it is pooling that has become the target for reform. For several years the pressure has been mounting within the American Institute of Certified Public Accountants to do something about pooling. Two research studies have been published by the Institute, one dealing with the merger transaction and one dealing with the unpopular aspect of purchase accounting — goodwill.[2]

Goodwill is the leftover in a purchase transaction. It comes about when the price paid for a company exceeds the aggregate current fair value that can be placed on the identifiable assets. The thing called goodwill by accountants can be goodwill in the popular sense; it can be cost of getting a head start, that is, a kind of combined organization expense and start-up cost; or it can be simply the excess of cost paid over the fair value of tangible assets received in exchange.

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[2] Catlett & Olson, *Accounting for Goodwill*, ARS No. 10 (1968); Wyatt, *A Critical Study of Accounting for Business Combinations*, ARS No. 5 (1963).

Usually there is not much objection to setting up goodwill; the problem is getting rid of it. The costs of all assets of a corporation, with the exception of those having a permanent value, ultimately find their way to the statement of profit and loss. The simple fact is that the existence of goodwill at any time or over any period is difficult to demonstrate and impossible to quantify. Thus, an accounting convention has developed whereby purchased goodwill must be recorded at cost, but write-offs may await demonstration that the goodwill has been dissipated. This means that the subsequent write-off may be all at once rather than by methodical charges to income over a period. Not everyone handles goodwill this way, however. There are many companies which follow the practice of orderly write-offs over a period.

This brings into focus the options available to merger engineers:

If instant earnings are available and you want them — pool;

If the combined companies show the proper earnings trend, and you want to add results of operations before and after the combination — pool;

If the combined earnings before the merger are more than they will be immediately after the combination, and you want to show only the earnings history of the acquiring company — purchase;

If the tax situation is such that a stepped-up basis is attractive, set up a taxable deal; this will ordinarily result in a purchase;

If purchase accounting results in substantial goodwill, substantiate its continued existence to avoid amortization against subsequent income; remember, goodwill amortization is not deductible — these are 100-cent dollars.

It should not be inferred that a completely free choice exists between pooling and purchase accounting. In spirit, pooling is supposed to apply where there is an exchange of equities only. There is some disagreement among accountants whether pooling accounting is required or permitted when appropriate conditions exist. Even under the more restrictive rules, however, it is usually possible to structure a transaction to achieve the desired result. The most difficult stumbling block is often the tax rule. Sellers generally want a tax-free deal while buyers often prefer a stepped-up basis. The tax rules for tax-free mergers are not identical with the accounting rules for poolings but they do interfere.

Activities of the Accounting Principles Board

The Accounting Principles Board (APB) is convinced that the time has come to change the rules of accounting for mergers. It has considered ways of restricting poolings, ways of eliminating poolings, ways of reducing goodwill, ways of writing off goodwill and, finally, ways of eliminating goodwill entirely.

This is an attempt to deal with all the accounting aspects of merger accounting in one *Opinion*,[3] an audacious and commendable effort. Indeed, it could be the most significant single accounting development in the financial world in many years, because the accounting rules may have a profound effect on merger activity itself.

There are many who feel strongly that unrealistic amounts of goodwill are being recorded in present-day mergers and, even more strongly, that amortization of such goodwill would result in an improper charge against earnings. An attempt to fit such a conviction into the present logical structure of accounting can produce a chain of reasoning like this:

First, comes the effort to restrict accounting to those business combinations that are true mergers. Such mergers have the characteristics of retention of businesses, inclusion of all assets of both companies, and continuity of ownership.

Second, comes the realization that such abstract characteristics are easily stated but impossible to apply. The biggest single reason is that their demonstration depends on events *after* the merger and after the accounting has been set.

Third, comes the idea of simply limiting poolings to companies with a certain relative size. This is quickly understood to substitute a mechanical rule for a concept and, therefore, to be workable only under adversary conditions.

Fourth, comes the feeling that poolings must go, because without the support of a business concept the accounting principle has no validity.

Fifth, comes the comprehension that the only alternative to poolings is purchase accounting which, if based on stock market valuations, can produce an enormous amount of goodwill. Stock prices of the conglomerates, just as much as those of other companies, discount hoped for future events. Where very large earnings multiples obtain, use of stock market quotations give very large purchase prices that probably could not be supported in sales of the same size blocks for cash.

Sixth, comes an attempt to avoid these large numbers by measuring these deals by the other side; namely, the value of the bundle of net assets received instead of the market value of the stock given.

Seventh, comes an appreciation that this requires assignment of a value to an asset, goodwill, that can have no measure other than cost. If cost determines value then value cannot determine cost.

Eighth, comes the conclusion that the only practical way to cut through this dilemma would be arbitrarily to limit the recording of goodwill to some predetermined set of conditions, such as where there is a demonstrable cost, *i.e.*, cash and other non-equity transactions where the cost can be measured.

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[3] This Opinion will be published in 1970.

To the writer this is an unsatisfactory solution, but a vivid illustration of the dilemma in which the APB finds itself.

IS THE POOLING CONCEPT VALID?

It is difficult to comprehend the forces that seek to eliminate poolings as an accepted accounting concept when it has proved so useful over the past 25 years. Surely some of the defenders of poolings sincerely believe in the concept. At least some of the users of the principle must have done so in good faith. Not all of them must have had sinister ulterior motives. What then accounts for the pressures to banish poolings of interest from the community of generally accepted principles of accounting?

The conclusion seems inescapable that the unpopularity of poolings is a direct outgrowth of the correlation between conglomerates and the distortions of "instant earnings" and "funny money." One suspects that the pressure on poolings would subside if "instant earnings" could be isolated and kept out of post-merger earnings per share, and if the obligations against the future created by unusual types of equity securities were made more evident. In other words, the need may be not for the elimination of the poolings concept but for the tightening of the accounting techniques conglomerate managements are alleged to have misused.

There is also a need for the clear articulation of poolings of interests as a business concept. Thus far, poolings of interest have been solely an accounting concept. The phrase is almost never used except in accounting discussion. If poolings are to survive, and the writer feels they should survive to avoid sweeping the goodwill question under the rug, they are going to have to be defined in business terms. This precludes use of relative size and other mechanical concepts and calls for a logical description of the transaction. Ideally, such a description would automatically show who should and who should not pool.

Heretofore, descriptions have been attempted of the pooling transaction by calling it a transaction between shareholders outside the business entities. This description carries little conviction because it depicts an unreal situation. The central core of the poolings idea is that the earnings stream should not be interrupted by the merger. All other ideas surrounding the concept are subordinate. To maintain the earnings stream means to retain the historical costs of investment in producing assets. Purchase accounting, on the other hand, produces a new set of costs, new estimates of useful lives of long-term assets, and all the other changes in measurements of earnings that occur when assets are sold.

Thus, if the concept of poolings is justified, it is necessary to establish that there is a set of conditions where a change in the holders of capital stock by a merger has no effect on the business conducted by the corporation.

So far in the business combinations debate, little attention has been paid to the nature of corporations themselves. Absent the private company concept, I suppose all corporations are legally equivalent. From a social standpoint, however, some are merely incorporated extensions of their owners' business activities. Others are independent, practically immortal, entities of their own.

The latter, it will be recognized, are the ones whose stockholders, in the words of Berle and Means,[4] have exchanged the privileges of ownership for the wages of capital. Having made such an exchange, the stockholders have no power or possibility of entering into transactions affecting the entire corporation.

It can be seen that the shareholders of this type of corporation are precisely the ones to whom the idea of a merger being a transaction between shareholders outside the business is least applicable. Corporations whose shareholders are in a position to negotiate a transaction of this magnitude are likely to be owned by a small, closely-knit group of shareholders. This type of corporation is likely to comprise simply an incorporated form of doing business by a small group of individuals. Mergers of such corporations are likely to be tax-free forms of sellouts. Viewed from another direction, they are likely to involve significant changes in the way of doing business.

Mergers by the publicly held corporation, on the other hand, are less likely to involve basic changes in the business. Obviously, some changes are probable or else the merger would not be justified. There is a difference, however, between changes resulting from the changes in management of the larger corporations, and changes resulting from the folding of a personally managed company into the impersonal structure of the modern publicly held corporation.

Seen in this light, one of the difficulties being experienced by the pooling concept turns out to be a poor method of expressing an idea. Instead of justifying a pooling on the grounds that it is a transaction by the stockholders, one should say it is a transaction on behalf of the stockholders.

Accordingly, the public corporations are the corporations to whom the pooling-of-interests concept appears to be valid. Thus, if two publicly held corporations merged solely through an exchange of equity capital, it is perfectly rational to take the position that nothing has happened to disturb the historical continuity of either. If, on the other hand, one of the companies is not publicly held we may assume the owners of that corporation have simply used a tax-free method of selling out their business.

A ready-made means of identifying publicly held corporations already exists in the definitions under the 1964 amendments to the Securities Acts. It will be recalled that, subject to certain other conditions, any corporation with equity securities held of record by more than 500 persons must register under the Securities Exchange Act of 1934.[5]

Additionally, a few corporations have achieved an existence of their

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4 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968).

5 15 U.S.C. §§ 78c, *l* (1964).

own without public ownership. These, as was recognized by Berle and Means,[6] are the small number of giant family corporations. They, too, should be eligible for the pooling concept, but under strictly defined rules. Unfortunately, the need for absolute objectivity overrides the desire for conceptual accuracy. Thus, conditions of relative size, continuity of management and continuation of the business, and perhaps even absolute size would have to be imposed on these relatively few candidates.

Only one type of transaction should be eligible for pooling treatment: the common stock for common stock transaction. This is the one that affects only the wages of capital. Transactions that introduce cash consideration, debt securities or preferential securities affect the corporation itself. These should not be considered pooling transactions.

With this framework it is logical to require that pooling transactions require pooling accounting, and purchase transactions require purchase accounting. The fiction of accounting for goodwill as if it did not exist because it is too hard to measure would be unnecessary.

A few cases of difficult valuations of transactions would persist. We can hope and forecast that these would tend to disappear, however, because the attractiveness of unusual securities would be reduced. The subterfuge of designing securities that appear like equity to the issuer and like debt to the holder would no longer be available.

CONCLUSION

In summary, it is not necessary to affirm or deny that abuses of accounting exist in the business practices of conglomerates. If they do exist, the proper target for attack is the accounting principle, not the conglomerate. Especially inappropriate is the indirect form of attack using poolings of interests as the primary target. Poolings of interests have a demonstrated history of usefulness and they can be defined in business terms to remove them from the area of alternative accounting techniques. Once this is done, poolings of interests will assume their rightful place in the business world, that of a form of business transaction that has its own appropriate accounting presentation — one that is appropriate for no other.

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[6] *See* A. BERLE & G. MEANS, *supra* note 4.