St. John's Law Review

Volume 44
Number 5 *Volume 44, Spring 1970, Special Edition*

Article 63

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FINANCIAL MOTIVES FOR CONGLOMERATE GROWTH

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In a recent article in the *Financial Analysts Journal,* Leonard M. Savoie, the Executive Vice President of the American Institute of Certified Public Accountants, observed that:

> The major problem area confronting the Accounting Principles Board in 1969 is business combinations . . . . The current wave of business acquisitions and mergers could not have taken place without tax laws permitting tax-free exchanges and the almost complete freedom of management to choose between purchase accounting and pooling-of-interests accounting.[1]

One cannot now be certain whether Mr. Savoie intended this observation to serve as a *mea culpa* for the Board, the Institute, or himself. I nevertheless agree that the accounting profession's laxity in imposing stricter standards of accountability on our major corporations has undoubtedly sparkplugged and then accelerated the current merger movement, which, from all indications, is destined to be the greatest such movement in history. One might well ask what took the Board and others in our "Accounting Establishment" so long to sense the social and economic consequences of the profession's accommodation to the proclivities of the merger-magnates? The handwriting was on the wall years ago, written large so that all could see — if only they would have looked.

One might also ask whether a profession, whose primary mission is that of historian for corporate society, should have permitted its precepts and practices to become sufficiently flabby and flexible to permit those who are the very subject of the presumptively objective and truthful narrative, *i.e.*, the professional managers of corporate society in whom such huge pools of power have been vested, to have "almost complete freedom" to choose the manner in which the epic narrative would be written.

THE ECONOMIC JUSTIFICATION FOR BUSINESS COMBINATIONS

There is little question that the economics-of-scale argument can be made in some cases; surely, if a computer has idle time it might be able to do the job for a nexus of corporations as well as for a single entity. Similarly, if incredibly ingenious management can mastermind cost-efficiency relationships in the case of automobile manufacturing, there is no reason why it should not be able to do the same for airplane manufacturing, typewriter

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[1] Savoie, *Meeting Financial Consumer Needs,* 25 FIN. ANALYSTS J. 47, 50 (1969).

production, or a distillery operation. The management mystique may lie in its ability to interpret the print-out from the computer and to inspire associates or disciples to implement the decisions of this group-think-tank. And since our advancing technology permits centralized and coordinated management to obtain instantaneous feedback on anything that is going on anywhere in the world, if not the universe, then such management should be able to coordinate action and activate decisions on a ubiquitous scale with the same pace and energy that our forebears exercised to operate the local carriage or bicycle shop. In brief, advancing technology permits a corresponding leap in geographic distances. Further, our decision-making models have increasingly been committed to quantification, almost to the exclusion of the qualitative (so that if that which is important cannot be quantified, we will make important that which is quantifiable); as a result, management has the expertise to make decisions about varied activities, even where it does not have the apperceptive basis for fully comprehending what a particular decision involves.

Thus, management may be seen to be both ubiquitous and omniscient —and if only it were also benevolent it would possess all the qualities attributed to the Deity; and some of the "Merger Kings" would begin to fancy themselves, if not exactly Divine, at least of Divine Origin and Inspiration. But in all seriousness, there is clearly an argument to be made for economics of scale.

Managerial Complacency and Arrogance

Similarly, there is no question that traditional managements were often both complacent and arrogant. They read too much of Galbraith and presumed that as long as they provided the shareholders with a nice, moderate yield on their investment and a nice, proper growth curve (consistent, say, with the growth in GNP or the industry generally), the shareholders would not complain. And if, in the pursuit of these objectives, traditional management permitted excess reserves to accumulate, and thereby produced a conservative balance sheet,[2] why should the shareholders object? And, as everyone knows, if the nice normalized income curves and the proper conservative balance sheet could be achieved without taking undue risks, why take them?[3] Again, Galbraith made clear that management's reward for accomplishment is not nearly symmetrical with punishment for failure. If shareholders at their "annual rites" raised objections to what management was doing, they could "lump it"; the microphones would be shut off and the meeting ad-

[2] This could be accomplished by depreciating properties far beyond their economic wear and tear, suppressing inventories by the use of LIFO, or writing off natural resource exploitation costs, and expensing currently all tools, research and development expenses, etc.

[3] It should be noted that our profession's body of principles and practices greatly facilitated traditional management's objectives of achieving that nice, slow growth curve, and producing a correspondingly safe, conservative balance sheet.

journed. And if they persisted in creating unrest, the next annual meeting could be held in Maine during the month of February — or some other natural punishment could be contrived. However, the recent merger movement did produce a new Damoclean phenomenon for management — namely, the take-over bid. Traditional management could no longer treat their shareholders with disdain. The threat of the take-over bid has encouraged a greater degree of participatory democracy in our corporate society, just as it has encouraged management to bring to the surface of the balance sheet the pools of asset values which they heretofore preferred to suppress.

OF CHARISMA AND SYNERGISM

To sum up the first thrust of this presentation, the merger managers were supposed to bring the qualities of charisma and synergism into the amalgamation. Through their youth and vigor, and their ability to eliminate accumulated fat, duplication, and other wasteful patterns of business activity, they were supposed to make two plus two equal five. And to prove it, take-over bids carried market-price tags giving the shareholders of the target companies stock profits beyond their dreams of avarice. Then, the "Merger Kings" would fulfill their prophecies and projections by producing income statements and balance sheets which were felicitous beyond anything seen heretofore. This felicity, in turn, added to the god-like aura of the King, permitting him to bring still more subjects under his spell and into his realm. And as he did so, the values attributed to the currency generated by the Merger King's printing presses (sometimes called "funny money") were further increased, making this currency even more valuable in future take-over negotiations, making more traditional managements quake, and so on *ad infinitum.*

What are the accounting problems which we have confronted in trying to fathom the effectiveness of the managements of our conglomerate complexes? To begin with, the fact that they generally report their operations on a smorgasbord or consolidated basis prevents us from determining just how much better they are really faring than their predecessors — or even if they are faring better. The consolidation permits a subsidy-effect to prevail, whereby especially profitable operations can obfuscate adverse operations in other areas. It is only when a combination of perverse factors converge at a particular time that the outsider can gain an insight into the internal difficulties. Such a convergence of perversity seems to have occurred, almost by coincidence, during the past year for a number of our leading conglomerates, including such giants as LTV, Litton, Automatic Sprinkler, and Gulf & Western. In fact, this process of obfuscation has prompted one cynic to observe that he could not discern how much "syn" and how much "gism" were subsumed in synergism.

This camouflaging consequence of the consolidation process has received critical notice from Congress, the Justice Department, and both the Federal Trade and Securities and Exchange Commissions. In response to such pressure, the Financial Executives Institute, through its Research Foundation, undertook a study to develop guidelines for financial reporting by diversified companies. Relying on this study, which was pursued with diligence by Professor R. K. Mautz, as well as on their own analyses, the SEC announced proposed amendments to the Commission's reporting requirements.[4] As a result, companies are now required to report sales and net income by lines of business, whenever any such lines comprise at least 10 percent of the corporation's revenues or income. This change is, of course, in the right direction. However, both the American Institute of Certified Public Accountants and the staff of the Cabinet Committee on Price Stability have commented critically on this proposal; the former believes the 10 percent test to be "overly detailed and of questionable value," whereas the latter group contends that the new disclosure rules will still not reveal enough, especially since they could require even less disclosure as the conglomerate expands.

THE POOLING — PURCHASE DICHOTOMY

Far more dramatic and even more controversial is the accounting dichotomy alluded to by Mr. Savoie, *i.e.*, the pooling versus purchase controversy. Briefly stated, these are the two alternatives described by the AICPA over a decade ago in Accounting Research Bulletin 48 (hereinafter ARB 48). The distinction between the two alternative methods of viewing business combinations must "be found in the attendant circumstances." The standards for this accounting duality are then "fleshed out" as follows:

> 3. For accounting purposes, a *purchase* may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporations is eliminated or in which other factors requisite to a pooling of interests are not present.[5]
> 4. In contrast, a *pooling of interests* may be described for accounting purposes as a business combination of two or more corporations in which the holders of substantially all the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations . . . and in which certain other factors . . . are present.[6]

Some of the "certain other factors" described by ARB 48 are:

> 5. When the shares of the stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessors, a new ownership or purchase of the predecessor is presumed to result. Similarly, if the

[4] SEC Securities Act Release No. 4988 (July 14, 1969).
[5] AICPA, *Business Combinations*, ARB Op. No. 48 (1957).
[6] *Id.* at ¶ 4.

> relative voting rights, as between the constituents, are materially altered . . . a purchase may be indicated. Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase.[7]

Various attendant circumstances which would contaminate the pool are also set forth:

> a. Abandonment or sale of a large part of the business of one or more of the constituents.
> b. If the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small.
> c. Where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 to 95 percent or more of the voting interest in the combined enterprise).[8]

In view of all that has been written about this controversy during the past year, even the less sophisticated observer should now realize that even if each of these logical standards for pooling had been violated in a particular case, the corporate management could still utilize the "pooling" technique. Thus, even if it is assumed that the exotic kinds of securities issued on the swap destroyed the relative shareholdings and "shareholder-power;" that the shareholders of the acquired corporation had explicitly been permitted to dispose of their interest in the combined enterprise; that substantial segments of the acquired properties and managements had been disposed of; that the interest of the acquired corporation in the combined enterprise was measurable only in the third or even fourth decimal; and that the acquisition had been deemed to be a taxable purchase; the combination could still be presented in the resultant financial statements as a pooling-of-interests!

Why this proclivity for pooling? Essentially, it is because ARB 48 set forth the following accounting dichotomy:

> 8. When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.[9]
> 9. When a combination is deemed to be a pooling of interests, a new basis for accountability does not arise. The carrying amounts of the assets of the constituent corporations . . . should be carried forward.[10]

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[7] *Id.* at ¶ 5.
[8] *Id.* at ¶ 6.
[9] *Id.* at ¶ 8.
[10] *Id.* at ¶ 9.

POOLING DYNAMICS EXEMPLIFIED

One might well ask how pooling accounting has been utilized to produce extraordinary earnings injections for the acquiring corporation. Let us consider briefly the 1967 acquisitions by Gulf & Western, with particular emphasis upon its acquisition of Paramount Pictures. In its 1967 statements Gulf & Western asserted that its earnings had more than doubled — from $22 million the previous year to $46 million. While this was certainly dramatic, supplemental data furnished by the report were even more euphoric. They revealed that companies acquired during 1967 contributed a whopping $22 million to the conglomerate's 1967 income, although these companies had earned only $2.6 million during 1966.

Whether this extraordinary increase in earnings was attributable to the special brilliance and genius of Gulf & Western's management depends on how one defines brilliance and ingenuity. The enormous profit inflation was triggered by Gulf & Western's wholesale disposition of television rights to the Paramount Pictures library. Gulf & Western simply disposed of properties which they had acquired in the acquisition of Paramount.

By using the pooling-of-interest method of accounting, the conglomerate was able to pay out over $184 million for its 1967 acquisitions, while reflecting only a cost of less than $100 million on its books. It accomplished this by equating the cost of the 1967 acquisitions with the written down (or written off) amounts shown on the books of Paramount and the other acquired companies, *i.e.*, $100 million. The other $84 million was free to be used to bolster reported earnings and, as asserted above, a good part of it was so used.

THE PSYCHEDELICS OF PURCHASE ACCOUNTING

In the intervening period, as a result of perceptive questioning by financial analysts, and especially because of an SEC policy statement in June 1968,[11] acquiring corporations have manifested a certain timidity of going into the pool, and have found that the sport of purchase accounting can be even more exhilarating than the pooling-of-interests variety.

Writers on the subject, myself included, had made an invidious distinction between pooling and purchase accounting, implying that if the one was evil, the other was benign. Consistent with this was the traditional wisdom. We presumed (naively, as it turned out) that if an acquiring corporation paying $49 million to acquire the securities of a book-publishing company was required to account for this transaction as a purchase, then, consistent with the standards of ARB 48, the $49 million would have been allocated to cash and receivables (net of liabilities), to inventories, fixed assets, copyrights, franchises, investments, and the like — all predicated on the fair market values prevailing at the time of the acquisition. Thus, we had presumed that

[11] SEC Securities Act Release No. 4910 (June 18, 1968), in [1967-1968 Transfer Binder] FED. SEC. L. REP. ¶ 77,567.

the sum of the parts would equal $49 million, and that the amount attributable to each of the parts would be derived out of that aggregate sum.

Here we were proven to be wrong — grievously wrong. Thus, when National General acquired Grosset & Dunlap, it paid $49,215,000. Of that sum, $33,049,000, approximately two-thirds of the purchase price, was charged to an "excess of the cost of investment" account; and this account is nought but goodwill spelled backwards. Only $16 million was charged up to the assets taken over on the Grosset & Dunlap acquisition. In other words, the royalty contracts, copyrights, franchises, and investments in the publishing company's subsidiaries will be carried into National General's accountings at Grosset & Dunlap's cost of $16 million — not the real cost to National General of $49 million. And of course, National General's future income data will be correspondingly enriched by this cost-suppression technique.

THE PURCHASE-POOLING HYBRID

Let us next consider, however briefly, the hybridization experiment conducted by Ling-Temco-Vought (LTV) when it acquired Wilson & Company. There, LTV bought 53 percent of Wilson for cash and acquired the remaining 47 percent for a new preferred-stock issue. The result was the "jackass" — part purchase-part pooling. It was all-fooling, however, since, to all intents and purposes, LTV ended up by taking over nothing more than Wilson's vestigial book values for its inventories and other properties. The excess paid by LTV on the 53 percent cash portion of the transaction was cozily categorized as an "excess of cost account"; and that's something that will never enter into the operating cycle of the Wilson operations. The 47 percent acquired for the preferred stock was accounted for as a pooling, so that the old book values were perpetuated here also.

To sum up this phase of our polemic, the pooling-purchase duality of accounting methods was supposed to produce substantially divergent results. In recent practice and in all too many important contexts, they have not necessarily been divergent; the distinction has been severely blurred, and to all intents and purposes, even eliminated.

Further, it has been emphasized that the accounting for business acquisitions has enabled the acquiring company to suppress substantial amounts of its costs and values, and then to bring these values to the surface in the form of reported profits (which were nought but specious profits) of the acquiring corporation. It is this fiction or speciousness which long gave to the Merger Kings their myth of invincibility. Finally, in this context, let us recall the point made by Mr. Savoie, to the effect that the selection of the accounting alternative rests primarily with management. These factors combined to produce the Emperor's charismatic and synergistic clothes which were of the most gorgeous hues and of the most gossamer filament — but only so long as the financial community wanted to go along with the deception. And when the child discerns the Emperor's nakedness, the accounting profession is cast in the role of the weaver.

MOVEMENTS TOWARD REFORM

Clearly then, there is disenchantment with the accelerated merger movement of the recent past. It has artificially distorted the profit goals and objectives of shareholders, giving them visions of growth curves far beyond those that could be developed by managements' blood, sweat, and tears, even in a growing and thriving economy. This wave has, in turn, upset the profit goals of our oligopolistic enterprise, inducing price increases which, in turn, helped trigger the inflationary spiral and adversely affected our world trade relationships.

Looking at the problem from the vantage point of an accountant, especially distressing is the realization that it was the very flexibility of our precepts, in conjunction with the lack of a forthright posture of true independence in practice, which made this merger wave possible in the first instance. It is the realization that we gave our hallmark to statements which were thereby presumed to be fair, but which were, as it now develops, mere collages of numbers brought together within the framework of our loosely defined, generally accepted accounting principles (or some unreasonable facsimile thereof). This permitted the weaving of a web of deception in which all too many of the 25 million shareholders have found themselves ensnarled.

Also distressing is the realization that the profession of accountancy has failed to recognize its responsibilities as a profession. Such a calling, we know, is endowed by our society with rights, privileges and immunities, in return for which we must accept a social responsibility. This responsibility should have demanded our assuming the leadership in correcting accounting gimmickry long before the present clamor for such changes.

And so we are pleased to believe that the conglomerate movement may have passed its zenith, even though we know it is not yet near its nadir. More importantly, we very much hope that from the major reappraisal occurring within the government, the financial community, the realms of the professions, the groves of academe, and commerce and industry, there will emerge a new and intensified commitment to a higher standard of fairness, truth, justice and equity; that we will dedicate ourselves to the eradication of the serious divergence between prevailing myth and underlying reality. Indeed, this divergence, as well as the resultant credibility gap, must be eliminated if our capitalistic institutions and our way of life are to be preserved.