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EPS GROWTH FROM FINANCIAL PACKAGING: AN ACCOUNTING INCENTIVE IN ACQUISITIONS

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I. INTRODUCTION

In the last few months popular business publications have been replete with references to "creative accounting," "chinese money," "EPS legerdemain" and other catchy and basically critical phrases. Such terms reflect the judgment that certain accounting principles have been sufficiently pliant and adaptable to permit managements to paint very impressionistic corporate financial portraits. The author concurs in this judgment and believes that several accounting techniques have meaningfully nurtured the recent conglomerate merger movement. This essay focuses on one of the techniques, financial packaging, *i.e.*, the form in which payment is made, and explores its forceful impact on earnings per share.[1] Under accounting conventions the computation of EPS involves dividing the dollar value of earnings available to common stock by the appropriate number of presently outstanding or anticipated shares of common stock. The heart of this essay is concerned with the divisor in this computation, the below-the-line figure.[2] The author attempts to (1) explain how and why the astute selection of an acquiring company's form of payment could minimize the divisor and maximize EPS; (2) identify the accounting profession's response to various financing packages; and (3) note the EPS aggrandizing techniques of financial packaging presently available. Other accounting incentives in acquisitions are only touched upon in order to identify their relationship to the core of this essay. The more important of these are given separate consideration in other articles in the Financial Disclosure section of this volume.

Dabblers in the stock market are doubtlessly cognizant of the relationship between a rising EPS and mergers. Nevertheless, the relationship is not self-evident. Hence, a brief comment on such a critical premise is appropriate. Two factors coalesce to create the connection. The first concerns corporate management's belief that one of its primary objectives is to increase the value of the company's common stock on a per share basis.[3] The

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1 The terms "earnings per share," "earnings per share of common stock," and "EPS" are hereinafter used interchangeably.

2 The major issues (especially the "purchase v. pooling" question) associated with determination of the earnings available to common stock, the above-the-line figure, are considered in Professor Russell A. Taussig's companion article in this *Symposium*, at p. 846 *supra*.

3 J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 7-8 (1968). *See* E. SOLOMON, THE THEORY OF FINANCIAL MANAGEMENT 22-23 (1963).

second factor pertains to the prevailing view that the value of a corporation's common stock is the present worth of all future dividends and reinvested earnings available to that stock.[4] The difficult computations inherent in the second factor are avoided, but the essence of the value concept is implemented by applying a multiple to current earnings per share.[5] Flowing from this stock market focus on EPS is the well-known propensity for publicly traded common stock to rise in price as EPS increases and as prospects remain good for further increases. This market mechanism, in combination with the first factor, prods management to utilize those accounting techniques and to take that corporate action calculated to increase EPS. An acquisition has been one type of corporate action uniquely capable of producing that increase.

II. Form of Payment

The accounting principles applicable to the computation of earnings per share have, throughout the merger movement, permitted management to show a variety of EPS figures, depending upon which form of payment the acquiring company selected to accomplish the acquisition. These principles, the options they afford, and the consequences of choosing one in lieu of another can most easily be understood against the background of the following hypothetical situation.

Seeker Corporation's new management has decided to strengthen the company's market position by expanding its product line. They can accomplish this either by developing new products internally or by acquiring an existing producer. The former route requires high initial capital outlays, as well as operating losses from the project for at least two years. These losses would probably reduce Seeker's earnings per share and market price. Consequently, management is seriously considering acquisition of Target Corporation, an established firm with the desired products. The acquisition, if made, would be achieved by buying all of Target's common stock for one of the following: common stock, cash, or convertible debentures.[6] Management's immediate concern is the impact of the proposed acquisition on Seeker's earnings and market price. Seeker and Target have the following security analysis profile:[7]

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[4] *See* Modigliani & Miller, *Dividend Policy, Growth and the Valuation of Shares,* 34 U. Chi. J. Bus. 411 (1961); Wendt, *Current Growth Stock Valuation Methods,* Financial Analysts J., Mar.-Apr. 1965, at 91. *See also* E. Solomon, *supra* note 3.

[5] *See* J. Cohen & E. Zinbarg, Investment Analysis and Portfolio Management 238-48 (1967).

[6] In this and subsequent hypothetical situations it is assumed that after acquisition Target is operated as a wholly owned subsidiary and that its financial statements are consolidated with Seeker's.

[7] To command a price/earnings multiple of 15, Seeker and Target would probably anticipate earnings growth in succeeding years. However, earnings growth from operations is ignored in this and subsequent hypotheticals in order to isolate the impact of the acquisition.

Seeker		
After tax profits for 1965	=	$4 million
Common stock outstanding	=	4 million shares
EPS	=	$1
Multiple	=	15
Market price of common	=	$15
Cash dividend per share	=	$.30
Debentures outstanding	=	0
Preferred stock outstanding	=	0
Expected after tax profits for 1966	=	$4 million[7]

Target		
After tax profits for 1965	=	$1 million
Common stock outstanding	=	1 million
EPS	=	$1
Multiple	=	15
Market price of common	=	$15
Cash dividend per share	=	$.30
Debentures outstanding	=	0
Preferred stock outstanding	=	0
Expected after tax profits for 1966	=	$1 million

A. Acquisition of Target Common Using Seeker Common

When companies such as Seeker with simple capital structures utilize common stock or cash to acquire another corporation, applicable accounting principles have dictated that the resulting consolidated EPS be computed by dividing the earnings available to the common stock by the number of shares of common stock outstanding.[8] Had Seeker effected the acquisition on January 1, 1966, issuing one million shares of Seeker common for the one million shares of Target common outstanding,[9] Seeker's consolidated earnings per share for 1966 would have been $1.00, assuming the earnings projections were met[10] and the acquisition was accounted for as a pooling of interests.[11] Although Seeker's after tax profits rose 25 percent, the number

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[8] *See* AICPA, *Earnings per Share,* ARB No. 49 at ¶ 4 (1958) [hereinafter cited as ARB No. 49]; AICPA, *Earnings per Share,* APB Op. No. 9 at ¶ 33 (1966) [hereinafter cited as APB Op. No. 9]; AICPA, *Earnings per Share,* APB Op. No. 15 at ¶ 14 (1969) [hereinafter cited as APB Op. No. 15].

[9] Naturallly Target's shareholders would have to perceive some collateral benefit to the offer if they were to accept comparable-value common stock. A discussion of such enticements is beyond the scope of this article.

[10] Earnings per share for 1966 would have been computed as follows:

$$\text{EPS} = \frac{\text{earnings available to common}}{\text{common stock outstanding}}$$

$$\text{EPS} = \frac{\$5{,}000{,}000}{5{,}000{,}000}$$

$$\text{EPS} = \$1.00$$

[11] A "pooling of interests" is a business combination, the major feature of which is that holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which, directly or through subsidiaries, owns the assets and businesses of the constituents. *See* AICPA, *Business Combinations,* APB Op. No. 49 at ¶ 4 (1957). The alternative accounting conceptualization of an acquisition is as

of shares outstanding increased by a like amount, and earnings per share remained as before. Since earnings per share did not change, we can expect the same multiple of 15 (assuming the same dividend pay out of 10 percent of $.10 per share) to be accorded Seeker's earnings unless investors immediately perceive some synergism in the combination. Thus, in terms of initial impact on shareholder's investment an acquisition with common stock is more alluring than developing the requisite new products internally.

It is important to be aware that the acquisition route is attractive even though the stock market assessment of the companies was identical prior to the acquisition. Had there been a disparity between the multiples, an acquisition using common would have been even more attractive than internal growth.[12]

B. Acquisition of Target Common Using Cash

Had Seeker used cash to acquire Target, the beneficial effect on earnings per share and market price would have been much more attractive than an acquisition for common. Assuming Seeker purchased for $15 million all one million shares of Target common, Seeker's consolidated earnings for 1966, computed pursuant to the same principles governing an acquisition for common,[13] would be $1.25.[14]

Seeker has purchased earnings, but the medium of purchase, *i.e.*, cash, does not enter into the earnings per share computation. Increased earnings are allocated to the same number of shares which were outstanding before the acquisition, and earnings per share move up smartly. Given the brisk

a "purchase." A purchase is a business combination in which an important part of the ownership interests of the acquired company is eliminated, or other factors requisite to a pooling of interests are not present. *Id.* at ¶ 3.

In a pooling of interests, the acquired company's assets are reflected in the acquiring company's consolidated balance sheet at their pre-acquisition book values. Thus, absent a change in the method of depreciation or the economic life of the assets, the acquired company's depreciation and amortization changes will be the same after the acquisition as they were before it. In contrast, were the acquisition accounted for as a purchase, the purchase price would be allocated to the allocated company's assets, with any excess of purchase price over the assets' fair market values being allocated to goodwill. Should the allocation result in increased book values for depreciable or amortizable assets, the charges against earnings from these items will rise and thereby restrain any anticipated earnings growth.

12 *See Earnings Per Share Growth from High Multiple Stock*, at p. 888 *infra*.

13 ARB No. 49 at ¶ 4; APB Op. No. 9 at ¶ 33; APB Op. No. 15 at ¶ 14.

14 Earnings per share for 1966 would have been computed as follows:

$$\text{EPS} = \frac{\text{earnings available to common}}{\text{common stock outstanding}}$$

$$\text{EPS} = \frac{\$5{,}000{,}000}{4{,}000{,}000}$$

$$\text{EPS} = \$1.25$$

Although this acquisition would doubtlessly have been accounted for as a purchase, the possibly adverse effects on EPS of increased depreciation and amortization have been ignored.

jump in EPS, one could predict the multiple accorded the new figure would expand from 15 to perhaps 17. The expected market value of the common is now approximately $21, an anticipated 40 percent increase over the market price attending the use of common, and an even greater increase above the likely market price were corporate growth to be accomplished via the non-acquisition route.

C. Acquisition of Target Common Using Seeker Convertible Debentures

The encouragement given acquisitions by the earnings per share computation should have been adequately demonstrated by the use of common stock and emphatically demonstrated by the use of cash. However, cash might not have been conveniently available to Seeker at the time and in the amounts needed. Instead of resorting to common when stock market multiples are similar, management might profitably have recourse to convertible debentures.

The earnings per share impact of convertible debentures and other securities representing potential dilution[15] has been one of the most controversial accounting topics in recent years. The past decade witnessed a three-stage evolution of the governing principles. In each stage it was possible, but progressively more difficult, to set the terms of the debenture so that earnings per share would approximate the figure generated by an acquisition for cash.

Assume that Seeker effects the acquisition by issuing $15,000,000 (principal value) 6 percent 20-year debentures convertible into common at $15 per share. These convertibles give Target shareholders a claim on the same one million shares of Seeker common which they controlled in the common stock example above.

First Stage (Prior to 1967)

Prior to 1967, the potential dilution inherent in convertible debentures was ignored when earnings per share were computed. This occurred despite the fact that applicable accounting principles stated that "the term *earnings per share* should be used to designate the amount applicable to each share of common stock or other residual security outstanding."[16] Common stock reserved for possible conversion of convertible debentures was clearly not "outstanding"; consequently, the question of whether the potential dilution would be reflected turned on whether or not the convertible debenture was an outstanding "residual security." Accounting Research Bulletin 49

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[15] In the author's view, the article's discussion of convertible debentures is representative of the accounting treatment accorded convertible preferred securities and is analogous to that accorded warrants. Although there are several interesting issues and accounting practices pertaining only to warrants, constraints on the length of the article preclude their consideration. Readers particularly interested in the warrant will find several of the issues treated in Hayes & Reiling, *Sophisticated Financing Tool: the Warrant*, 47 HARV. BUS. REV. 137 (Jan.-Feb. 1969).

[16] ARB No. 49 at ¶ 4.

did not define the term, and accountants customarily treated convertibles as non-residuals.[17] This practice would have permitted Seeker to acquire Target using convertibles and to show EPS of $1.25 in 1966,[18] in contrast to $1.00 in 1965. Again assuming the upward surge of earnings stretches the multiple to 17, the anticipated market value of the common would be approximately $21, to the delight of common stock owners and owners of the convertible debentures. A convertible debenture representing a claim on 66.67 shares of common at a time when the common sells for $21 generally has a market value of at least $1,400, whereas a comparable number of Target shares prior to acquisition represented a market value of only $1,000.

In addition to providing Seeker with the same benefits as cash, convertible debentures, as an acquisition tool, offered another advantage — they were more acceptable to Target's stockholders. Those stockholders could retain an interest in the company and anticipate an increase in the market value of the convertible as a result of the rise in the market price of the common. For those stockholders oblivious to these prospects, Seeker could offer an additional enticement. Anticipating the value-creating effect of the convertible, Seeker could share that value in advance by offering to buy Target common at a premium above the market price of $15 per share. For example, instead of offering $1,500 principal amount of convertible debentures for 100 shares of Target common, Seeker might offer convertible debentures with a face value of $1,650. Such magnanimity would not be expensive. The premium would not have to be paid in cash until the convertible debenture matured 20 years hence. Indeed, if the securities were converted, the premium need never be paid. Naturally, Seeker would not wish to supplement its largess with an increased claim on common stock. Consequently, the conversion price might be fixed at $16.50 per share, thereby limiting Target's debenture holders to control of the same number of common shares as in the earlier convertible example.

In this early phase of the merger movement, convertible debentures truly possessed a special magic, and that magic emanated to a considerable degree from accounting principles which tolerated disregard of the convert-

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[17] APB Op. No. 15 at ¶ 8.

[18] Earnings per share for 1966 would have been computed as follows:

$$\text{EPS} = \frac{\text{earnings available to common}}{\text{common stock outstanding \& residual securities outstanding}}$$

$$\text{EPS} = \frac{\$5{,}000{,}000}{4{,}000{,}000}$$

(6 percent interest would be deductible for tax purposes whereas dividends on common would not be.)

$$\text{EPS} = \$1.25$$

As in the cash example in note 14 *supra*, EPS would likely be a bit less than $1.25 because of increased depreciation or amortization resulting from the probable treatment of the acquisition as a purchase. For simplicity the effect is ignored.

ibles' potential dilution when computing earnings per share. The Accounting Principles Board ushered in stage two when it released Opinion No. 9, which was designed to change the above situation.

Second Stage (1967-1968)

Opinion No. 9[19] made two significant changes affecting earnings per share. After reiterating the earlier definition of EPS as the "earnings applicable to each share of common stock or other residual security outstanding,"[20] it went on to define, for the first time, a residual security as an outstanding security that "clearly derives a major portion of its value from its conversion rights or its common stock characteristics."[21] Moreover, the Board required that if the potential dilution of a company's common stock was still material after the first computation, the company should provide shareholders with an additional or pro forma earnings per share calculation.[22] The pro forma figure would reflect all dilution whether attributable to convertible debentures, convertible preferreds, warrants, or options.[23] Additionally, this dilution was to be reflected even if the relationship between current market and conversion prices made conversion or other contingent issuance unlikely in the foreseeable future.[24]

In light of Opinion No. 9, Seeker's acquisition of Target would have produced either a single EPS figure of $1[25] or a dual presentation, with the primary figure showing EPS of $1.25[26] and the pro forma figure showing EPS of $1.[27] Even if the convertibles were not residuals,[28] the dual presentation

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[19] APB Op. No. 9 was issued by the Accounting Principles Board in December 1966, and was effective for accounting periods beginning after December 31, 1966.

[20] APB Op. No. 9 at ¶ 33.

[21] *Id.*

[22] *Id.* at ¶ 43.

[23] *Id.*

[24] *Id.* at ¶ 44.

[25] This computation would be made as follows:

$$\text{EPS} = \frac{\text{earnings available to common}}{\text{common stock outstanding \& residual securities outstanding}}$$

$$\text{EPS} = \frac{\$5{,}000{,}000}{4{,}000{,}000 + 1{,}000{,}000}$$

(The assumption of conversion requires the assumption that interest need no longer be paid on the convertibles.)

$$\text{EPS} = \$1.00$$

[26] *See* note 18 *supra.*

[27] *See* note 25 *supra.*

[28] The following example will demonstrate the operation of the residual concept. Seeker's convertible debentures have reached their anticipated market price of $1,417 (66.67 shares per bond multiplied by $21.25 per share of common) and the question is whether the security "clearly derives a major portion" of that $1,417 value "from its conversion rights." In practice, major seemed to mean 50 percent of value, and the 50 percent was determined by reference to the assumed investment value the convertible debenture would have had, had it not been converted. *See* Weston & Davidson, *Accounting Changes and Earnings*, Financial Analysts J., Sept.-Oct. 1968, at 61. Thus a judgment would have

would eventually deny Seeker some utility from the $1.25 figure; the juxtaposition of the diluted figure with the undiluted was calculated to motivate investors to question their simplistic reliance on reported earnings per share. A credibility gap eventually did develop between heavy issuers of convertibles and the investment community. This skepticism percolated down from the sophisticated to the naive, until multiples and market prices ceased to increase automatically when convertibles were used.

Third Stage (1969-present)

Opinion No. 9 was basically an effective updating of accounting principles to deal with a problem, *i.e.*, undisclosed potential dilution, which did not exist to any noteworthy extent before the recent merger movement. However, there remained some technical difficulties with the residual concept. That concept required a rather complex judgment: the determination of the convertible debenture's investment value.[29] It was also theoretically capable of having a fluctuating impact on earnings per share.[30] These problems were eliminated by APB Opinion No. 15.

In Opinion No. 15, the APB discarded the residual concept and replaced it with the following: the primary EPS figure should be "based on the outstanding common shares and those securities that are in substance equivalent to common shares and have a dilutive effect."[31] The possibility of a fluctuating impact on EPS was obviated by specifying that the determination of whether a convertible debenture is a common stock equivalent should only be made at the time of issuance, and should not be changed as long as the security is outstanding.[32] The problem of determining investment value is averted by the following simple and objective test: "a convertible security should be considered as a common stock equivalent at the time of issuance if, based on its market price, it has a cash yield of less than 66⅔ of the then current bank prime interest rate."[33]

The impact of these tests upon Seeker's EPS would be difficult to predict. Assuming hypothetically, but reasonably, that Seeker's convertible debentures have a market value at issuance of $1,000 to $1,050,[34] Seeker's 6

to be made as to the market price of a Seeker straight debenture paying 6 percent interest and maturing in 20 years. Assuming arbitrarily that such a debenture would sell for $800, only $617 ($1,417 – $800) of the $1,417 would be attributable to the conversion feature and consequently, the CD would not be a residual security.

29 *See* note 28 *supra*.

30 For example, should the market price for Seeker's common remain the same in 1968, but interest increase enough to depress the assumed investment value of the convertible debenture below $700, the convertibles would be residual securities for 1968 and primary EPS would be diluted. If in the following year, interest rates remain the same but the market price of the stock drops from 21 to 19, the convertible would not be a residual for 1969, and the dilution of EPS would be reversed.

31 APB Op. No. 15 ¶ 15.

32 *Id.* at ¶ 28.

33 *Id.* at ¶ 33 (footnote omitted).

34 Although a value of $1,400 for Seeker's convertible debenture is anticipated as a consequence of the acquisition, this value will probably not appear until sometime after

percent interest payment will represent a cash yield of between 5.7 and 6 percent. Such yields are more than 66⅔ percent of the present (February 1970) prime bank rate at 8½ percent, and Seeker's convertibles are therefore not common stock equivalents under Opinion 15. Note, though, how close the outcome is; a market price at the time of issuance of only $1,075 would make the securities common stock equivalents.[35]

Seeker's management might be tempted to insure minimum dilution of the primary EPS figure by increasing the stated interest for the convertible debentures. Such increases would have to be made judiciously; cash outflow must be minimized, and Seeker must avoid the impression of credit weakness created when debt instruments are issued at rates exceeding those enjoyed by comparable companies. In addition, full dilution would nevertheless be disclosed in the pro forma figure.

In summary, use of convertible debentures would have permitted Seeker to show EPS as follows:

prior to 1967		$1.25
1967-1968	primary EPS	1.25
	pro forma EPS	1.00
1969-	primary EPS	1.25
	pro forma EPS	1.00

Prior to 1969, and particularly before 1967, these EPS figures compared favorably with those generated by acquisitions for cash. The combined effect of amenable accounting principles and investors' typical response to EPS increases spawned financial packaging flexibility, as well as value-creating possibilities for those managements willing to grow by acquisition. Now, generally accepted accounting principles will produce at least one figure comparable to an acquisition using common stock. However, the revised accounting principles remove neither the beneficial EPS effect of a cash acquisition nor a common stock acquisition's avoidance of the early drag on earnings which often attends internal growth. Thus, accounting principles governing computation of earnings per share still facilitate acquisitions, although not to the dramatic degree they did prior to Opinion No. 9 and the response thereto.

D. Earnings Per Share Growth From High Multiple Stock

An immediate increase in EPS also occurs whenever a company's common stock is acquired with common stock having a higher multiple. Under-

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the debenture's issuance, that is, after the market has had an opportunity to assess the ramification of the acquisition.

35 The time of issuance is generally the "date when agreement as to terms has been reached and announced, . . ." *See* APB OP. NO. 15 at ¶ 29. The terms in a public offering are typically not set until the morning the securities come to market (just before the price amendment to the registration statement is filed), and therefore the "time of issuance" would seem to include the first day of trading. Since the vagaries of the marketplace will affect the determination of common stock equivalency, Seeker's management would be uncertain of the securities' EPS effect prior to public sale.

lying this phenomenon are the same accounting principles used to compute earnings per share — with one distinction. Whereas the earlier discussion focussed on the accountants' perception of the common stock equivalency (or lack of it) of cash and other securities, the present phenomenon turns on the fact that accountants make no independent judgment of the intrinsic values of securities; they disregard differences in the multiple which the investment community accords both the acquiring and the acquired companies' stock.

An example will serve to underscore these observations. Suppose Seeker had acquired Target for cash, and suppose further that, as anticipated, the market price of Seeker's common rose to $21 per share. Seeker now acquires for common stock all of the common stock of Quarry Corporation, a concern with the following security analysis profile:

After tax profits	=	$1,250,000
Common stock outstanding	=	$1,250,000
Earnings per share	=	$ 1
Multiple	=	10
Market Price of common	=	$ 10

Since Quarry's common has a market value of $10 per share, while Seeker common sells for $21, one half of a share of Seeker common gives its holder slightly more market value than one share of Quarry. Assuming for purposes of simplicity that Seeker acquires all of Quarry's common stock on exactly these terms, Seeker would have to issue 625,000 shares of stock. If the acquisition were effectuated on January 1, 1967, and if both companies had the same after tax profits in 1967 that they had in 1966, Seeker's earnings per share would be $1.35,[36] up from $1.25.

The Quarry hypothetical is a conservative one. Imagine the EPS growth when the acquiring company's multiple is 50, 75, or even a hundred points higher than that of the acquired company's. Furthermore, Quarry had only one fourth of Seeker's earnings. At this juncture, one should pause and reflect upon the EPS to be enjoyed should Quarry's quantum of earnings be similar in size to, or larger than, Seeker's.

It must also be noted, however, that the use of disparity in price-earnings multiple to advance earnings per share is somewhat risky. Investors might perceive the lower multiple company to be sufficiently dominant in the combination to require adjusting the acquiring company's multiple downward to, or toward, the lower multiple. Furthermore, contemplative investors might value earnings created by financial or accounting acumen less than those created by research, production, or marketing talent; this

[36] $$\text{EPS} = \frac{\text{earnings available to common}}{\text{common stock outstanding}}$$

$$\text{EPS} = \frac{\$6{,}250{,}000}{4{,}625{,}000}$$

$$\text{EPS} = \$1.35$$

judgment might also result in a reduced multiple for earnings per share and a status quo stock market position.

For managements willing to assume these risks, the accounting principles governing the computation of EPS increased the desirability of acquisitions in each of the three accounting epochs of the merger movement. Once savored, the accounting treat is difficult to abstain from; both a growth record and the expectation of future growth demand further acquisitions as a means of gratifying profit appetites.

III. Related Accounting Incentives in Acquisitions

A. *Discretionary Treatment of Expenses*

Management has broad discretion in the handling of many expenses. They can reduce or eliminate expenditures for those items which make no immediate contribution to revenues (*e.g.*, research and development). This operational decision will reduce reported expenses and increase profits. In addition, management can exercise the discretion available to it under generally accepted accounting principles to change the method of accounting for past and recurring expenses. Where management is so inclined, this discretion may be exercised to minimize expenses and thereby maximize EPS where there is no change in the exercise of operational discretion. This accounting legerdemain encourages the merger movement in two ways. First, the astute use of discretion permits optimal positioning of the company's common for acquisitions using the disparity of multiple technique. And even if a growth curve and multiple disparity are not possible from the discretionary handling of expenses,[37] maximized earnings will at least facilitate a common for common acquisition on the most favorable terms possible under the circumstances. In other words, if Seeker, sporting a price/earnings multiple of 10, acquires Target, whose EPS is $1 and whose multiple is 10, Seeker will typically minimize dilution if its EPS is $2 rather than $1.

The second impact from the discretionary handling of expenses occurs after an acquisition is made. Opportunities may be found in the acquired company for sharply reducing future expense through altered accounting techniques.[38]

Among the more important areas in which discretion can affect earnings are the following:

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[37] Discretionary changes, such as shifting from accelerated depreciation to straight line, can be made only once. In the year of the change, earnings will increase relative to those reported for the prior year. However, in subsequent years the change only tends to maintain earnings at the new high level, not increase them.

[38] *See, e.g.*, Gulf & Western Industries, Inc., 1966 Annual Report, Note A, at 56. When Gulf & Western acquired New Jersey Zinc in the former's 1966 fiscal year, New Jersey Zinc followed the practice of immediately expensing certain mineral exploration and development costs. Gulf & Western chose to amortize those costs in the future as the minerals were extracted. Although the post-acquisition earnings benefit flowing from this change is not available, an idea of its magnitude can be gleaned from the change's impact on the restated prior year's earnings. Including earnings improvements from accounting changes made in another acquisition, earnings for fiscal 1965 increased $1,437,451.

1. *Depreciation.* Determination of the economic life of the asset.[39]
2. *Depreciation.* Determination of the appropriate method of depreciation.[40]
3. *Research and Development Costs.* Determination of whether to capitalize these costs and amortize them over the life of the project, or alternatively, whether to expense them currently.[41]
4. *Inventory Valuation.* Determination of whether to utilize the LIFO (last-in, first-out) or FIFO (first-in, first-out) inventory valuation technique.[42]
5. *Goodwill.* Determination of whether to amortize the goodwill created when an acquisition is treated as a "purchase," and if so, over what period of time.[43]

B. *Extraordinary Items*

Prior to APB Opinion No. 9, growth-oriented managements were able to affect earnings favorably through their handling of extraordinary items of income or loss. For example, the sale of a block of stock at a profit created the temptation to include that income in the computation of EPS,[44] whereas the uninsured destruction of a facility by hurricane created the temptation to charge the loss directly to retained earnings. This possibility was considerably circumscribed when Opinion No. 9 stipulated that such extraordinary items be segregated from the results of operations, and be shown in the income statement[45] and in a separate EPS computation.[46] Nevertheless, an area of judgment does remain. Extraordinary items result from "events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating process of the business."[47] Thus, in the judgment of some companies with large portfolios, gains on their partial liquidation are not extraordinary when recurring profitable liquidations are anticipated.

C. *Pooling*

Heretofore, we have only considered acquisitions of common stock in January, with the acquired company thereafter being operated as a

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39 For example, IBM uses an economic life of 4 years for the IBM 360 computers which it leases, whereas Continental Computer utilizes an economic life of 10 years for the IBM 360's it leases.

40 For example, IBM depreciates its 360's at an accelerated rate, whereas Continental Computer utilizes straight line for its 360's.

41 *See* note 38 *supra.*

42 In a period of rising prices such as the 1960's, FIFO produces a lower cost-of-goods-sold figure and a higher net profit than LIFO.

43 This subject is treated briefly in note 11 *supra* and in the discussion of *Pooling, infra.*

44 Extraordinary items do include losses (such as result from the expropriation of property or the devaluation of foreign currency), but there has predictably been little desire by acquisition-minded companies to include such losses in the computation of EPS.

45 APB Op. No. 9 at ¶ 17.

46 *Id.* at ¶ 32.

47 *Id.* at ¶ 21.

wholly owned subsidiary. If we hypothesize an acquisition which occurs toward the end of the acquirer's annual reporting period, for example, on December 31, the last day of that period, two very important questions are highlighted: what quantum of the acquired company's earnings are includable in the computation of EPS, and how are the assets of the acquired company reflected on the surviving corporation's balance sheet?

The answers to the foregoing hinge upon whether the acquisition is considered by the accountants to be a "purchase" or a "pooling of interests." A purchase would enable the acquiring company to pick up the acquired company's earnings subsequent to the date of acquisition.[48] Alternatively, treatment as a pooling makes it pleasantly necessary to pick up earnings prior to, as well as subsequent to, the date of acquisition.[49] The appeal of pooling to a growth-oriented company is manifest. Typically, there is an unquestionable advantage in picking up 365 days worth of earnings instead of 1.[50]

Pooling is also likely to have the more favorable impact on earnings in subsequent years because of the manner in which the balance sheet is affected by the acquisition. Purchase necessitates the allocation of the purchase price to the various acquired assets, and the treatment of any excess over the book value of those assets as goodwill.[51] These higher book values yield larger depreciation and amortization charges in future years, and consequently exert a downward pressure on EPS. In sharp contrast, pooling permits the combination of the two companies' balance sheets with no change in the book value of assets and no creation of goodwill;[52] since there is no change in the assets' bases for depreciation, there is no change in the charge against the earnings flowing from the continuing depreciation of those assets.

In the author's opinion, pooling's particular incentive for acquisitions has resided in the opportunity it provides for management to tailor earnings. If an earnings-concerned management discovered near year's end, or even thereafter, that earnings growth would not reach expectations — perhaps they would even be below the previous year — they could hustle out and make an acquisition, being sure to qualify it as a pooling, and thereby increase the year's EPS and justify their claim to a continuing growth trend. This particularly distinctive and valuable feature of pooling will probably be eliminated by an opinion of the Accounting Principles Board to be released in the near future.

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[48] *See* ARB No. 48.

[49] *See* AICPA, *Omnibus Opinion-1966*, APB Op. No. 9 at ¶ 5 (1966). However, it appears likely that Accounting Principles Board Opinion No. 17, which had not been released as of February 3, 1970, will change this feature of pooling.

[50] Had the acquisition been made on January 1st of the year rather than December 31st, pooling would not have had its singular earnings advantage. The purchase technique would also have made available 365 days of earnings.

[51] *See* ARB No. 48 at ¶ 8.

[52] *Id.* at ¶ 9.

IV. Conclusion

Accounting principles have undeniably given incentives to the conglomerate merger movement. This has been possible because of a conflux of phenomena: management's perception of its responsibilities and self-interest; the posture of accounting principles at the beginning of the movement; investors' often simplistic perception of accounting data; and closely related to the last point, the mechanism whereby common stock market prices are determined. A by-product of the foregoing's interaction has been the signal importance for EPS in the determination of the market value of common stock; EPS became the accounting pivot for the conglomerate merger movement.

In the author's opinion, accounting's encouragement of mergers was directly proportional to the degree to which accounting principles afforded management the means to increase EPS independent of energetic, creative and successful operating efforts.

The single greatest incentive was embedded in the principles governing computation of EPS. Those principles permitted, and still permit, cash and common stock (where there is a disparity in the price/earnings multiple) to have a particularly stimulating effect on EPS. The discretionary handling of expenses and extraordinary items contributed as well. Supplementing the foregoing were, and are, those principles embodying the basic conceptualization of an acquisition as either a "purchase" or a "pooling of interests." The latter has given management extremely valuable flexibility with regard to the timing of its acquisitions.

Particularly sophisticated hybrid securities such as convertible debentures, convertible preferreds and bond warrant units constituted a separate chapter in the saga of accounting incentives in the conglomerate merger movement. Their impact on EPS endowed them with a special incentive early in the movement. They contain fewer accounting incentives today, for the accounting profession, speaking through the Accounting Principles Board, in response to outside pressure and its own perceptions, modified the applicable accounting principles. Modification was implemented through a concept of disclosure: inform the investment community of such important facts as the source of earnings and potential dilution, and allow that community to draw its own conclusions. Although investors were initially perplexed, while others have objected, with some justification, that these modifications were too long in coming, such disclosure, combined with the public's reaction, has deprived the hybrids of much of their accounting utility.

At present, the accounting focus of attention is shifting to the concept of pooling. Assuming the accounting principles governing that doctrine will become more restrictive, acquisition will still contain accounting incentives, particularly when the alternative is internal growth and particularly when cash or high multiple common stock is the form of payment used to establish ownership.