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Homer Kripke

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CONGLOMERATES AND THE MOMENT OF TRUTH IN ACCOUNTING†

HOMER KRIPKE*

We run our economic and financial lives burdened with an error of fact that is as obvious as it is all-pervasive. We apply mathematical treatment to business facts, confident that they will generate reliable conclusions just as accurately as observations of physical facts enabled men to make the computations that put us on the moon. Thus, we operate with rules like: "A company with an annual earnings growth rate of 15 percent compounded should sell for 22 times this year's earnings." But we do this, some not knowing, and some relying on the stupid brokers and customers who shape the market not to know, that the basic datum of earnings is not an objective fact but the product of the accountant's art or artifice.[1]

Similarly, the whole science of economics has become increasingly mathematical, with learned authors taking twenty pages bristling with calculus formulae or feedback diagrams to explain how they built their "models," before they disclose what they are about to discuss[2] — and again, many of the statistical raw materials of the computation are the products of the accountant's artistic imagination.

The conglomerate phenomenon presents these aspects of life in such a concentrated form that it has caused many to realize or finally to admit what should have been obvious before; but, unfortunately, there is indication that it will not force the basic decisions that would be necessary to stop this fantastic fallacy that our edifice of economic and financial statistics is built on distorted images, behind which there may be no reality.

I

To avoid misunderstanding, let us make clear that it is not accountants' fault that economic or accounting data cannot be measured like physical facts with scientific instruments. These data do not exist in nature; they are man-made, and man can make any rules governing them that he chooses.

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† To aid the reader the following short forms of citation have been utilized throughout this section:

1. The American Institute of Certified Public Accountants will be referred to as the AICPA.
2. The Accounting Principles Board's Statements will be cited as APB STAT.
3. The Accounting Principles Board's Opinions will be cited as APB OP. NO.
4. Accounting Research Studies will be cited as ARS NO.

* Professor of Law, New York University. A.B., University of Michigan, 1931; J.D., University of Michigan, 1933.

1 *See, e.g.*, Taussig, *Combinations, Permutations, and Pooling*, p. 846 *infra*, and his discussion of the *AMK* case.

2 *See, e.g.*, ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (H. Manne ed. 1969).

The sore point is that it is taking so long to agree on the rules. Two observations must be made here.

A. Who should make the rules? We must first distinguish between the techniques of bookkeeping and the principles of accounting. The technique of double-entry bookkeeping is a magnificent achievement that will, with marvelous flexibility and accuracy, process any data that are fed into it. It is as wonderful in its way as a computer, but like the computer, it is subject to the principles of GIGO — "garbage in, garbage out." The processed results are no better than the raw data that are given to the system. Shaping the raw data of economic life into the dollar figures of accountancy is the function of "accounting principles"; but there is no reason to suppose that the accountant is the only, or the best, judge of how we are to formulate the dollar symbols for real life. It is not only an accountant's problem to decide whether accelerated depreciation or straight-line depreciation best reflects the expiration of costs of fixed assets. It is not only an accountant's problem to decide whether an earnings statement will be most useful if we take the annual expense of depreciation as a percentage of historical cost or as a percentage of the current value of the asset that is consumed. Accounting principle is too important to be left exclusively to accountants. Yet, a distinguished accountant assailed another accountant member of a committee on which I recently served when the latter suggested that an accounting principle should jibe with the state of the law:

> I am not clear on why it is necessary to check with legal counsel. Isn't our objective to develop the right accounting principle? What happens under corporate law is another matter entirely.[3]

Accountants have claimed the privilege of determining accounting principle with scarcely any consultation with other disciplines which, in my opinion, should be equally entitled to a voice as to how our economic activity is to be symbolized in dollars. The Accounting Principles Board has no members other than accountants. Nine years ago, I urged that the pooling and goodwill problems were not exclusively accounting problems, and should be restudied by a committee with a broader base.[4] The recommendation was ignored and the Research Studies[5] were planned, made and completed exclusively by accountants with only ex post facto invitations for suggestions from other groups.

B. In a manner totally inconsistent with its pretensions as the sole arbiter of accounting principle, the accounting profession (except for the limited group of pronouncements of the Accounting Principles Board and its predecessor) has ceded control of accounting principle to the group least

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[3] Confidential Letter to Homer Kripke.

[4] *See* Kripke, *A Good Look at Goodwill in Corporate Acquisitions*, 78 BANKING L.J. 1028 (1961).

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

interested in the development of a sound and consistent body of principles: clients interested in putting their best foot forward.

This astonishing result stems from the rule that financial statements of a company are primarily the responsibility of management, and that the "certifying" accountant *must* express the opinion that the statements fairly present the condition of the company and the result of operations in accordance with "generally accepted accounting principles" (g.a.a.p.) if there is substantial authoritative support for the principles followed. Simplifying somewhat, this means that unless the question falls within the relatively few problems for which the Accounting Principles Board has prescribed or proscribed an accounting treatment, any treatment, and as many treatments as sizable groups of corporate managers choose to follow, is within g.a.a.p., and may, and *must*, be certified by the accountant. Thus the same accountant can, and *does*, certify totally inconsistent treatments by different clients as being in accordance with g.a.a.p. So long as this situation exists as widely as it does, accounting results will not be comparable, will be subject to manipulation[6] and will remain a trap for the unsophisticated.

It is obvious that some accountants like things this way. The accountant's responsibility is minimized if he can justify his certification as being in accord with g.a.a.p. because his client's version of the facts is no worse (or just a shade worse) than a reasonable number of other companies' versions of the facts of economic life. Fully twenty-five years ago, the writer reviewed what is still an influential book of accounting essays, and concluded that the author's recurring explanations that accounting principles could not be unified in area after area added up to: "the whole philosophy . . . in favor of a degree of flexibility so great as to leave the accountant irresponsible because no norms are left to which he must conform."[7]

One can understand and sympathize with the accountants' fearfulness. The same abyss of open-end liability to the public that caused Chief Judge Cardozo in *Ultramares Corp. v. Touche, Niven & Co.*[8] to draw back from his recognition of liability for negligent misrepresentation[9] must still give the accountants pause. But Cardozo's policy decision was overridden by Congress in the federal securities acts;[10] and it is incredible that so many accountants could have been found to testify that the accounting in the *United States v. Simon (Continental Vending)*[11] case did not violate

[6] *See* note 1 *supra*.

[7] Kripke, Book Review, 53 YALE L.J. 825, 829 (1944).

[8] 255 N.Y. 170, 174 N.E. 441 (1931).

[9] *See, e.g.*, Doyle v. Chatham & Phenix Nat'l Bank, 253 N.Y. 369, 171 N.E. 574 (1930); International Prod. Co. v. Erie R.R., 244 N.Y. 331, 155 N.E. 662 (1927); Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922).

[10] *See, e.g.*, Escott v. Bar-Chris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Fischer v. Kletz, 226 F. Supp. 180 (S.D.N.Y. 1967). *See also* Kurland, *Accountant's Legal Liability, Ultramares to Bar-Chris*, 25 BUS. LAW. 155 (1969). As will be seen, I do not agree with Mr. Kurland's disapproval of *United States v. Simon*. *See* note 11 *infra* and accompanying text.

[11] CCH FED. SEC. L. REP. ¶ 92,511 (2d Cir. Nov. 12, 1969).

accounting principle because there was no pronouncement of the Accounting Principles Board which required disclosure of the obviously material facts which the accountants knew. Judge Friendly's conclusion is obviously sound, *i.e.*, that "fairly presents" in the accountants' certificate means something objective on which persons other than accountants may have a view, and not (if the witnesses were to be believed) the present shockingly low level of g.a.a.p.

How did accountants get that way? One answer is still valid 25 years after the writer proffered it in another situation in which the profession found nothing wrong with the performance of one of its leading firms[12] after the SEC had declared:

> We should have hesitated to criticize the accountants on individual items had we not been unequivocally satisified that the financial statements, looked at as a whole, were not truthfully informative and should never have been certified.[13]

The writer's explanation in *Associated Gas and Electric Co.*,[14] and now again in *Continental Vending*, was that "the Council members, called to sit in judgment upon a colleague, were thinking, 'but for the grace of God, there go I.' "[15]

But accountants are as honorable as any other professional group. The shocking deterioration of standards in the abuse of pooling and related matters, documented in Professor Abraham J. Briloff's writings[16] as well as in several of the papers herein, seems to show the profession as men with backbones of over-cooked spaghetti. But the problem is not personal or peculiar to this profession; it is the murderous pressure to which accountants are subjected by clients under the anomalous situation mentioned — that the laymen interested in achieving a result to suit themselves, who don't give a damn about accounting principle, are permitted to select the accounting, and then demand a certificate because their antics are not much worse than those which other accountants have certified for other clients. There can be no general progress in accounting until the accountant puts his own integrity on the line unmistakably by certifying that the principles used are those that *he* (not his client) deems appropriate on the facts. Judge Friendly's opinion in *Continental Vending* ought to point the way, but it has aroused only sullen resentment, not movement toward this view of the accountant's obligation.

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[12] *See Report of Action of the Council of the American Institute of Accountants in the Matter of Associated Gas and Electric Company*, 77 J. ACCOUNTANCY 162 (1944).

[13] Associated Gas and Elec. Co., 11 S.E.C. 975, 1058 (1942).

[14] 11 S.E.C. 975 (1942).

[15] Kripke, *supra* note 7, at 828 n.12.

[16] *See, e.g.*, Briloff, *Out of Focus*, BARRON'S, July 28, 1969, at 5; Briloff, *The "Funny-Money" Game*, FIN. ANALYSTS J., May-June 1969, at 73; Briloff, *Much-Abused Goodwill*, BARRON'S, April 28, 1969, at 3; Briloff, *Dirty Pooling: How to Succeed in Business Without Really Trying*, BARRON'S, July 15, 1968, at 1; Briloff, *Distortions Arising From Pooling-of-Interests Accounting*, FIN. ANALYSTS J., March-April 1968, at 71; Briloff, *Dirty Pooling*, 42 ACCOUNTING REV. 489 (1967).

II

The pooling and goodwill controversies, as Messrs. Wyatt and Spacek note in their article herein, are not peculiar to conglomerates, but they are highlighted by the frequency of acquisitions by conglomerates. These problems literally throw into question the whole structure of modern accounting. The questions are incredibly difficult and the writer does not pretend to have the answers. But the first step in searching for an answer that will endure is to state the problem meaningfully, without jargon. Prior attempts[17] to state these problems were not meaningful, because they posited two separate types of business combinations, for which purchase accounting and pooling are respectively appropriate. Then they sought to state "tests" to distinguish the two. The tests were rapidly eroded, as they failed to deal with reality or define the problem meaningfully. The draft solution being formulated by the Accounting Principles Board will be no more successful, because it again refuses to state the problem. The Board correctly recognizes that there are not two classes of corporate combinations different in nature, for which different principles of accounting are appropriate. It therefore first proposed to abolish pooling, and, at last reports, will preserve pooling on a basis so severely limited as to satisfy neither those who demand preservation of pooling, nor those who want pooling totally eradicated. Despite the apparent support in the Stanger, Taussig and Hill articles, herein, for an effort to state a proper field for pooling, I question whether tests to distinguish the nature of pooling transactions can be successful. The APB's "exposure draft" is filled with learned assertions about standard accounting principles, and never views the problem with a breadth sufficient to relate the problem and the accounting to the modern world.

The problem, it is submitted, is clear, and deserves the type of meaningful presentation it is accorded in the Seidler article, even if the answers are not apparent. Value is recognized as the present worth of future earnings. We have a modern "conglomerate" phenomenon of aggregates of earning assets moving from one ownership to another, as the acquirer seeks to better its earnings per share; and the question is simply whether the earnings of the acquired company can be preserved in the transfer or are destroyed by accounting rules. There are two aspects to this problem:

A. Fixed assets are accounted for at historical cost to the owner regardless of subsequent general inflation[18] or increase in comparative value. Historical cost determines the level of depreciation charges affecting earnings reported pursuant to g.a.a.p. on the acquired company's books. If purchase

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[17] *See, e.g.,* AICPA, *Business Combinations,* ARB No. 48 (1957).

[18] *See* AICPA, *Financial Statements Restated for General Price-Level Changes,* APB STAT. OP. No. 3 (1969). These "price level" statements would at best be supplemental, and necessarily so, for they would clearly be beyond the comprehension of the layman already bewildered by the financial history of a modern dynamic company. Moreover, in many cases, the problem of disjunction of earnings after an acquisition arises because of the comparative inflation (beyond price-level changes) of building and natural resources values.

accounting is followed on the acquisition, the increased values must be recorded as new costs under g.a.a.p., and the increased depreciation charges destroy the earnings. Accounting must be wrong one time or the other, for accounting does not make sense in the modern world where the same assets and the same operations produce different earning results in the acquiring company's hands and in the acquired company's hands because depreciation charges change. Either pooling must be permitted to preserve the old costs in stock acquisitions, or depreciation charges in the hands of the acquired company must be based on current values, so that depreciation will not be disrupted following a transfer.[19] The Wyatt and Spacek article, herein, discusses this point admirably. The heightened inflation and this problem of shifting ownerships must force accounting to face this problem soon.

B. A modern acquisition is frequently at a price higher than even current values of specific tangible assets. The excess is called "goodwill", or a mixture of intangibles. It obviously represents the earning power or going concern value of the assets in productive process, rather than as individual resources. The going concern values arose from trial and error, correction of mistakes, ironing out of "bugs," seasoning, experimenting with men until there was a good team, *etc.* These values are genuine, but they are never recorded as assets on the books of the acquired company because the costs were immediately expensed to operations. In purchase accounting the acquisition puts them on the books of the acquiring company as goodwill, where they again hurt earnings if the goodwill is amortized.

Professor William A. Paton, Sr. has long called for a further study of intangibles.[20] This problem will never be solved by broad pronouncements about classes of goodwill as in the present stage of accounting pronouncements in Chapter 5 of *Accounting Research Bulletin 43*,[21] but only by restudy of the accounting for the expenditures that build goodwill which are

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[19] The writer played a small part in accounting's present adherence to the cost principle on fixed assets. *See* Kripke, *Accountant's Financial Statements and Fact-Finding in the Law of Corporate Regulation*, 50 YALE L.J. 1180 (1941). This article arose from the writer's participation in an SEC staff level committee study of the problem, at which time the SEC firmly set its face against appraisals of fixed assets. The writer reasoned that the balance sheet is basically a repository of costs not yet charged to operations, and that therefore, the balance sheet should show the historical costs which would subsequently go through the income account during operations. But query whether the true depreciation expense of today's operations is a fraction of historical cost of fixed assets, or is a fraction of the present value (and foregone opportunity for sale) that expires in operations.

[20] *See* Professor Paton's comments to ARS No. 10, *supra* note 5. His approach seems much more sound to me than that of the Arthur Andersen firm, whose argument as to whether goodwill is a resource or a dissipation of stockholders' equity seems to me to be mere verbalism. This viewpoint appears herein in the article by Messrs. Wyatt and Spacek of that firm, and in ARS No. 10, written by Messrs. Catlett and Olson of that firm.

[21] AICPA, *Restatement and Revision of Accounting Research Bulletins*, ARB No. 43 (1953).

treated as exclusively current expenses without a surviving asset on the books of the acquired company, and by restudy of the accounting for acquired goodwill which is preserved by continuing expenditures after an acquisition.

Conclusion

Beyond these specific questions is the need to rethink the fundamental accounting concept, that it accounts for entities, so that it is perfectly proper to have a disjunction when the assets are transferred from one entity to another. This was perfectly appropriate thinking for individual assets. It is simply inadequate under modern conditions where emphasis is on earnings, and going producers of earnings — "profit centers" — are transferred with dizzy frequency.

These problems are not easy. The problems of estimating and revising values are staggering. But the way to solve problems is to face them, by a reexamination of principles that creak of obsolescence, instead of concealing them by mere reassertion of the principles, as the coming pronouncement of the Accounting Principles Board shows promise of doing.