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### Accounting Principles and Conglomerate Growth

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# ACCOUNTING PRINCIPLES AND CONGLOMERATE GROWTH

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During 1969, and to a lesser extent in earlier years, substantial criticism was levelled at the so-called conglomerate companies. Agencies of the federal government charged with protecting the public from antitrust and monopoly abuses were particularly critical, but even the general business and financial press became critics of conglomerates. The aggregate effect of these criticisms is presently difficult to assess, but it seems reasonable that the deterioration in stock market prices of conglomerate companies may reflect in part the cumulative impact of these criticisms.

Criticism concerning the status of accounting principles has been prevalent for a number of years, dating back at least to the mid-1950's. However, only recently has such criticism moved outside the accounting fraternity, that is, to publications and periodicals not aimed principally at professional accountants. The diverse audience is largely the result of relating certain "accounting principles" to the growth of conglomerates. Thus, in effect, professional accountants found themselves blanketed with conglomerators as the joint recipients of widespread criticism in the business community.

## WHAT IS A CONGLOMERATE?

The term "conglomerate" lacks precision of definition. While it is not a particularly new term, its use to describe certain business combinations, for example, "conglomerate mergers," and certain corporations effecting such mergers, increased markedly in the late 1960's. Many businessmen used the term to describe the results achieved from numerous acquisitions made by their companies. Rather than vertical combinations (moving the nature of the business back into supply areas or forward toward ultimate consumers) or horizontal combinations (broadening the market penetration), these acquisitions were principally directed at diversification from existing product lines or market areas. While diversification has many goals, in the conglomerate era a principal goal was to permit successful management to bring its expertise to bear in a broader business arena. Since the evolving professionalism of management would permit better management and increased efficiency in operation of the acquired businesses, it was postulated that higher profits would result.

Prior to 1969, most managements did not object to having the con-

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glomerate label pinned on their businesses. Being a conglomerate was synonymous with being a growth company. The stock market attached a premium to companies so labelled, and numerous business and financial publications hailed the wave of conglomerates as the new era of business evolution.

We might define a conglomerate as a multimarket company that operates through many individual entities. If this is a fair definition, nearly two-thirds of the 500 largest manufacturing companies listed by *Fortune* would be classed as conglomerates. Conglomerates achieve growth largely by combination with other companies. However, many corporations not bearing the conglomerate label also achieve a large measure of their growth through combination. Corporate combinations are an inherent part of dynamic and growing nations, both developed and developing. Progress in any nation rests on increasing productivity and optimum use and development of resources. In fact, combination and growth of productive enterprises are as much a part of life as the growth of a child into manhood and into an integral part of a family. Small companies must have available an avenue for evolution into stronger units, to become integral parts of a larger unit that is capable of greater and more efficient production.

Actually, almost every one of today's corporate giants is the product of one or more mergers. Without these mergers, our nation's capacity to produce goods and services would very likely be only a fraction of today's production. The attack on conglomerates today by the Justice Department is principally an attack on the newly emerging giants. Companies that became giants in the past are allowed to remain giants. Thus, the current policy of the Justice Department could well result in lessened competition, since the newly emerging conglomerates could create a fair competitive matching for the existing corporate giants.

By 1969 the conglomerate label had lost its brilliance, at least in the stock market and public press, and was being used widely in a derogatory sense to apply to any company whose acquisitions had interfered with the status quo. Many factors contributed to this change in image for the conglomerates, but the fact remains that a conglomerate is a company that has grown by numerous acquisitions, with the acquisitions moving the company into new markets and products through a number of individual entities. The nature of the conglomerate did not change, only the image did.

Some question could be raised concerning the impact on public opinion of the relatively extensive criticism levelled at conglomerate growth (and bigness in business in general) in recent months. In a report issued November 15, 1969, Opinion Research Corporation reported the results of a survey on government regulation of business. The survey indicated the following views, among others<sup>1</sup>:

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<sup>1</sup> Opinion Research Corporation, ORC Public Opinion Index, Nov. 15, 1969.

[1] More than two-thirds of the public today think that large companies should be permitted to grow bigger.

[2] Hardly anyone [8% of those surveyed] thinks that the "bigness" problem should be handled by breaking up large companies and limiting their operations.

[3] By far the most acceptable solution to the problem of "bigness" in business, in the eyes of the public, is to have the government regulate big companies to see that they don't fix prices and kill competition.

#### WHAT ARE ACCOUNTING PRINCIPLES?

The term "accounting principles" also remains ill-defined. Most commonly, "accounting principles" relates to an expression in the normal report of an independent accountant on a company's financial statements. In this report the independent accountant states his opinion that the financial statements presented are fairly stated in accordance with "generally accepted accounting principles." While this reference to generally accepted accounting principles might imply that a full statement of such principles exists, this is not the case. Some accounting principles do exist in authoritative statements, but others are somewhat like common law — they exist in usage only.

The most authoritative statements on accounting principles are contained in 51 "accounting research bulletins" issued from 1939 to 1958 by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (AICPA) and in fifteen "opinions" of the Accounting Principles Board (APB), the successor to the Committee on Accounting Procedure. These bulletins and opinions deal with various technical accounting matters, for instance, how to account for income taxes, pensions, inventories, leases, business combinations, *etc.* The independent accountant who reports on financial statements of a company must assure himself that the company has kept its accounts in accordance with the accounting procedures specified. Any deviation therefrom must be noted in his report.

Unfortunately, too many of the accounting "principles" set forth in these bulletins and opinions are equivocating, *i.e.*, they permit the use of equally acceptable alternatives. Likewise, in certain difficult areas the accounting profession has taken many years to express a preferred position. In some, no preferred position is expressed even today. The end result is that readers of financial statements are led to believe that the statements are fairly presented when in fact the accounting principles followed, while generally accepted, do not always lead to fair presentations.

In the last few years the APB has issued opinions on several troublesome matters which have had significant effects on financial reporting, for example, income tax allocation,<sup>2</sup> reporting results of operations,<sup>3</sup> and

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<sup>2</sup> AICPA, APB Op. No. 11 (1967).

<sup>3</sup> AICPA, APB Op. No. 9 (1966).

determination of earnings per share.<sup>4</sup> These opinions have focused increased attention on the APB and the accounting profession. The increased general awareness about accounting principles has led to an increase in the level of criticism concerning accounting principles in financial and business articles and periodicals. The formerly intramural skirmishes within the accounting profession have been extended to the business community broadly. Several writers have matched up their criticisms of conglomerates with criticisms of the state of things in the accounting principles area. As a result, both conglomerators and independent accountants find themselves being criticized by the financial press.

ACCOUNTING PRINCIPLES APPLY EQUALLY TO CONGLOMERATES AND TO  
NONCONGLOMERATES

The fusion of the criticisms levelled against conglomerates and accounting principles creates the illusion that certain accounting practices, available to conglomerates, are not available to other companies. To the contrary, the accounting principles used by conglomerators are equally available to other companies. In fact, many of these principles have been used by a number of nonconglomerate companies. Criticisms of conglomerators for their selection of accounting principles would seem unfair under these conditions. The criticism should more justly be focused upon the unsound (but generally accepted) accounting principles.

The fact is that the accounting profession is not motivated either to prevent or to enhance conglomerate growth. Accounting is not designed to prevent anything, but has an overriding central objective to achieve fairness in financial reporting to all segments of society. If fairness of communication is achieved, accounting will assist in guiding growth to its proper maturity. Thus, the accounting profession has not developed any new accounting principles or practices in the 1960's which could be cited as fostering conglomerate growth. Likewise, any efforts by accountants to tighten existing rules which conglomerators (and others) have used in recent years must be motivated by a central desire to achieve improvement in accounting principles. While such a limitation of existing rules might mean that it will be more difficult to consummate mergers, such cannot be the motivation of the rule tightening. If accounting rules are properly established, they will not interfere with the natural growth of any company.

Accounting principles and practices are applicable to all businesses. Accountants recognize a continuing need to eliminate weak practices and to narrow the range of alternatives available to apply to a given business transaction. Accounting principles must have only one objective—to communicate to the reader of a financial report the economic facts surround-

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<sup>4</sup> AICPA, APB Op. No. 15 (1969).

ing transactions that occur. That objective does not include passing judgment on whether the transaction should have occurred.

#### CRITICISMS OF ACCOUNTING PRINCIPLES AND PRACTICES USED BY CONGLOMERATES

A number of the accounting practices or conditions recently criticized as having been misused by conglomerates have been in existence for many years. In all cases the practices discussed in the following paragraphs have been used by business broadly and not only by conglomerates. These accounting deficiencies are often compounded in a conglomerate context simply because of a greater number of acquisitions and the added visibility which these acquisitions create.

##### *Failure to Account for Inflation's Effects*

The accounting profession in the United States has traditionally ignored the effects of inflation. The general rationale used for this position is that inflation has not been severe enough in the United States to warrant accounting recognition. However, the profession has never indicated what level of inflation, either in a single year or cumulatively over a number of years, would be great enough to warrant recognition.

The facts are that since 1945 inflationary effects have had a steady influence. Consider the following changes since 1945:

- (1) Consumers Price Index has doubled.<sup>5</sup>
- (2) American Appraisal Construction Index has gone up almost four times.<sup>6</sup>
- (3) Gross National Product Price Inflation Index has doubled.<sup>7</sup>
- (4) Dow-Jones Industrial stock market average has gone up over five times.<sup>8</sup>

These changes in price levels mean that the carrying amounts for many assets in financial statements are understated, and therefore misleading and useless. The carrying amounts are far removed from current realities and present-day values. While this is a condition that exists for all corporations in varying degrees, depending on their asset mix by years of acquisition and other accounting policies adopted, the cumulative effect of the failure to recognize inflation is dramatized only when a business combination occurs. Then the inadequacies of accounting become obvious.

Since conglomerates by definition engage in numerous business combination transactions, the deficiencies in accounting in relation to inflationary effects are highlighted. The same accounting deficiencies exist, however, in financial statements of nonconglomerates. The accounting pro-

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<sup>5</sup> UNITED STATES BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 345 (90th ed. 1969).

<sup>6</sup> *Id.* at 691-93.

<sup>7</sup> *Id.* at 310.

<sup>8</sup> *Id.* at 456.

fession's failure to account for inflationary effects leads, therefore, to deficiencies in the financial reports of virtually all companies, not just those of conglomerates.

#### *Inadequate Accounting for Costs*

Other accounting practices generally accepted for many years produce results in certain industries similar to those arising from a failure to recognize inflation's effects—understatement of asset carrying values. These practices relate to accounting for costs incurred in the acquisition and development of assets. Many of them have stuck with us from medieval times of proprietary ownership, even though they are not properly related to accountability of assets to absentee owners. If all these costs were capitalized on a reasonably accurate basis, balance sheets would contain amounts for assets much closer to the value of the assets. In many cases these amounts, when also adjusted for inflation's effects, would be the best evidence of value that could be established for these assets.

The industries most affected by inadequate cost accounting practices are principally involved in natural resource development, although nearly all companies are affected to some extent. As with the failure to recognize inflationary effects, these deficiencies have received inadequate attention. The deficiencies become obvious, however, when a business combination occurs, since the owners of the acquired corporation will demand to be compensated for the full value of their assets whether or not the costs of these assets have been properly capitalized.

The principal sources of asset understatement related to inadequate cost accounting practices are: (1) costs of discovery, development, and growth in all natural resource industries; (2) several costs of an indirect nature relating to plant construction; (3) cost of product development and research activities; and (4) acceptability of the "LIFO" method of inventory accounting. In nearly all these cases, deductibility of the costs for income tax purposes has influenced the accounting treatment of them. As a result, at the time of a business combination significant adjustments are necessary if the acquiring company is to record properly the costs of assets acquired.

These inadequate methods of accounting for costs of assets are widely accepted by business. Attention is focused on them particularly when a business combination highlights the deficiencies. However, conglomerates are not really receiving any preferential treatment here. The deficiencies run to accounting for assets generally.

#### *Pooling-of-Interests Accounting*

Pooling-of-interests accounting is one of two alternative methods (the other being purchase accounting) generally available to account for most business combinations. Pooling-of-interests accounting views a business

combination as a "marriage" of the constituents to the transaction. No new basis of accountability is established. The amounts at which assets and liabilities are recorded in the accounts of both or all predecessor companies simply are carried forward to the accounts of the continuing or resulting enterprise. The fair values of the separable resources and property rights of the absorbed business at the time of the transaction are ignored, even though these values likely affected the terms of the combination.

As initially conceived, pooling accounting had rather limited application. It was to be applied only to combinations of two businesses, roughly equal in size, that retained both the management and ownership interests of both constituent enterprises. However, as the criteria restricting the use of pooling accounting became more ineffective, pooling accounting became increasingly popular. It is now considered an acceptable alternative to purchase accounting (wherein the fair value of all assets, including intangibles, of the acquired company would enter the acquiring company's accounting records) for almost all combinations affected by issuing voting stock. These alternatives have served to confuse accounting for business combinations.

Pooling accounting lends itself to a number of questionable uses. When the book values of tangible assets differ greatly from their fair values (as is frequently the case because accountants ignore the effects of inflation and follow questionable practices in accounting for the costs of many assets), a substantial but spurious profit can be reported. For example, land held by a real estate development company may have a book value which is only a small fraction of its real value. If the land development company is acquired and pooling accounting followed, the land can be carried over to the acquiring company at its book value, immediately sold by the continuing company, and the profits reported as earnings for the period. The substance of such a transaction is to issue capital stock and credit the proceeds of the issue to earnings.

Under another questionable use, a company which has failed to achieve its earnings goals can delay issuance of its financial statements and acquire another company under a pooling of interests. The profits of the acquired company for the entire year may then be included in reported earnings.

Pooling accounting suppresses any accounting for intangibles, including goodwill, and thereby eliminates the embarrassment of dealing with goodwill on the books of the continuing enterprise. Goodwill is a dubious asset on the balance sheet and is of little significance in evaluating a company's financial position. Pooling accounting also avoids current valuation of tangible assets and the generally higher depreciation charges resulting from the write-up to current values. The product is a brighter earnings picture for the combined entity.

The goodwill issue, principally the required amortization of goodwill by charges to income, has been central to the controversy over pooling ac-



counting from the time pooling accounting first gained acceptability. The amortization of goodwill creates a charge against earnings that is arbitrary and unrelated to the period of charge. Required or mandatory amortization of goodwill is objectionable to businessmen not only because of its impact on earnings, but also because it injects a meaningless element into the determination of income. Many accountants also find mandatory amortization to be objectionable, since the charge-off frequently flies in the face of observable enhancement in value.

Pooling accounting, through the nonrecognition of goodwill, eliminates the need for amortization of goodwill and the undesirable consequences flowing from amortization. This is one aspect of pooling accounting that achieves a desirable end-result from the viewpoint of most businessmen and many accountants. While the route to this result is a devious one, and in spite of the several defects of pooling accounting, elimination of the need for goodwill amortization may well prove to be significant enough to support the continuation of pooling accounting.

As noted, pooling accounting is one of two equally acceptable methods of accounting for business combinations. Thus, companies heavily involved in combination transactions must expect to bear criticisms arising from deficiencies in the pooling-of-interests method. While the method is available to companies generally, conglomerates, because of their considerable combination activity, find greater occasions to use it. Likewise, their exposure to criticisms for its use is greater.

### *The Novelties in Complex Securities*

A somewhat different sort of problem arose in connection with the variety of complex securities that appeared on the scene in the 1960's. While accountants had dealt with convertible bonds, convertible preferreds, second-class commons, and warrants prior to the 1960's, the significant increase in their usage and the new characteristics they carried caught the accounting profession somewhat unprepared. The profession had not previously found it necessary to issue a statement establishing accepted accounting practices for these complex securities. Thus, practice simply evolved, and that which developed was not always consistent with the basic nature of the transaction.

For example, accountants were generally content to permit the label attached to a security to determine its accounting treatment. It soon became apparent, however, that labels were misleading. Neither the Securities and Exchange Commission nor any other governmental agency developed standards quickly to require proper labelling for novel securities being issued. Thus, accountants relied heavily on labels. For example, a stock labelled "preferred" was so considered even though its dividend rate was nominal, its preference in liquidation miniscule, its voting rights on a par with related common stock, and its conversion terms indicative of a high probability of conversion within a relatively short period.

While accountants were debating the merits of alternative approaches to accounting for these complex securities, conglomerates were grinding them out by the millions of dollars worth. That recipients did not fully understand the nature of what they were receiving gradually became apparent. The conglomerators, the accountants, and the government regulators were all forced to bear the resulting criticism which each merited to some degree.

### *Standards for Disclosure of Earnings Per Share*

A matter closely related to that of the complex securities was the inadequacy of standards for determining and disclosing earnings-per-share data.

By the mid-1960's American companies could voluntarily disclose earnings-per-share information if they so desired. Standards for determining per-share data were minimal, and the accounting profession's policy was, in fact, to discourage attaching a high degree of significance to per-share data. Again, a partial vacuum existed. Standards for per-share data presentation were ill-defined at the same time as earnings per share became "the name of the game" in the merger and acquisition arena.

The standards used by those active in mergers and acquisitions, the conglomerates, were the same as those used by more mature companies relying on internal developments for growth. These standards proved to be inadequate, however, to deal with the new and complex security packages that the acquirors and their investment bankers were putting together to facilitate acquisition activity. Too often the form of securities—their labels—determined their nature for per-share computations. The misleading nature of the results obtained in some cases became only too apparent, and, as with the other deficiencies in accounting practices, the conglomerators and their accountants were forced to bear the criticisms.

### THE ACCOUNTING PROFESSION CAUTIOUSLY MOVES TO AMEND CERTAIN PRACTICES

As early as 1958 the accounting profession revised its established machinery for researching difficult accounting matters and issuing releases on them to guide practitioners. The details of these revisions and a thorough consideration of their relative effectiveness, or lack thereof, are beyond the scope of this paper. However, it is significant to note that one of the first research studies commissioned in 1959 was to study accounting for business combinations.<sup>9</sup> Another was to study how better to account for the effects of inflation.<sup>10</sup>

Unfortunately, this revised format—essentially a more substantive

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<sup>9</sup>Wyatt, *A Critical Study of Accounting for Business Combinations*, ARS No. 5 (1963).

<sup>10</sup>STAFF OF ACCOUNTING RESEARCH DIVISION, AICPA, REPORTING FOR FINANCIAL EFFECTS OF PRICE LEVEL CHANGES (ARS No. 6 (1963)).

research effort and a new working board, the Accounting Principles Board — inherited a mass of unresolved and critical problems. The APB began an immediate attack on these problems, even though it had not agreed upon (in reality, it had not even seriously considered) the purposes and objectives of the financial statements that would reflect the results of the opinions they proposed to issue. In the eyes of some accountants, the efforts of the APB were virtually doomed to an early failure. Without establishing certain key benchmarks for guidance and evaluation, the Board was likely to find certain problems too difficult to resolve and the solutions reached on others lacking in necessary internal consistency.

Disregarding these defects, it should be clear that the APB was not motivated in its attack on deficient accounting practices by any desire either to foster or to forestall the merger movement. Rather, the APB was motivated by a recognition that too often equally acceptable alternative practices existed to account for a given transaction. Financial statement users were likely to be unaware of the permissiveness of alternatives, and accordingly were inclined to take unwarranted comfort in the auditor's reference to "generally accepted accounting principles."

During its brief history the APB has issued fifteen opinions and three statements (statements are not mandatory in their effect on practicing accountants, but are more in the nature of recommendations). These opinions and statements are equally effective for all companies, whether or not they are conglomerates. Certain of these opinions and statements, however, have concerned accounting problems discussed in the preceding section. Their effects, therefore, are likely to appear more significant to conglomerates if for no other reason than that conglomerates have been identified with these problem areas.

### *1. APB Opinion No. 14*

In Opinion No. 14 (March 1969) the APB clarified certain matters concerning accounting for convertible debt and debt issued with stock purchase warrants. Part of the confusion existing in these areas was of the APB's own making, since it originally had dealt with these topics in Opinion No. 10 (December 1966) and had subsequently suspended its conclusions in Opinion No. 12 (December 1967). At any rate, history establishes that the APB was alert to the problem area as early as 1966, certainly at a date prior to the time when criticism of conglomerates became fashionable.

The principal problem dealt with in Opinion No. 14 concerned how to account for the proceeds of a convertible debt issue or a debt issue with stock purchase warrants. While in both cases the security issued is clearly labelled as debt, certain features tend to make the substance of the security less clear. This complexity generated questions as to the appropriateness of accounting for them simply as debt.

The APB concluded that convertible debt sold at a price or issued at a value not significantly in excess of the face amount should be accounted for as straight debt. No portion of the proceeds from issuance of such a security should be attributed to the conversion feature. The inseparability of the debt and the conversion option carried considerable weight in these conclusions. On the other hand, the APB concluded that the portion of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital.

The conclusions reached in Opinion No. 14 appear to be sensible and cognizant of the nature of the securities being considered. One could hardly conclude that the conclusions reached were punitive in nature as to any group of debt issuers. The Opinion clarified an unsettled area, one the APB had had under consideration for over three years.

## 2. APB Opinion No. 15

Opinion No. 15 is the most recent in a series of authoritative pronouncements on earnings per share. In 1958, the predecessor committee to the APB issued Accounting Research Bulletin No. 49<sup>11</sup> which in general decried the significance attached to earnings-per-share data but did provide certain broad guidelines as to proper statistical calculation. It introduced, without description, the term "residual security." The implication was that certain securities, residual securities, were in substance the equivalent of common stock and should be so considered in calculation of earnings-per-share data. However, prior to the issuance of Opinion No. 9 by the APB in December 1966, securities other than those labelled as common stocks seldom entered the per-share calculation.

In Opinion No. 9 the APB strongly recommended the disclosure of earnings by per-share data in the income statement. While this strong recommendation did not make disclosure mandatory, it did lead to an increase in reporting of per-share data. Opinion No. 9 also described more fully the nature of a residual security and provided guidelines on how to make the calculations of per-share data.

However, the complexities of securities issued in combinations outpaced the APB's pronouncements. In May 1969, Opinion No. 15 was issued to deal more completely with presentation of per-share data. In this Opinion the APB concluded that earnings-per-share data were so significant that such data should be shown on the face of the income statement. This position was significantly stronger than the "strong recommendation" of APB No. 9. In addition, the APB, in some detail, presented guidelines for the calculation of "primary earnings-per-share" and "fully diluted earnings-per-share." The residual securities concept introduced earlier was refined and the label attached to such securities changed to "common stock equivalents."

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<sup>11</sup> Committee on Accounting Procedure, AICPA, ARB No. 49 (1958).

Common stock equivalents were defined as securities possessing characteristics more like common stock than like senior securities. Securities meriting classification as common stock equivalents under Opinion No. 15 are to be treated essentially the same as common stock in computing earnings-per-share data. Guidelines were established so that complex securities whose underlying characteristics were not clear could be classified either as common stock equivalents or as senior securities. Thus, for example, a convertible preferred stock or a convertible debenture yielding an amount at issuance of less than  $\frac{2}{3}$  of the bank prime interest rate at that date is deemed to be a common stock equivalent for purposes of calculating earnings-per-share. Thus, Opinion No. 15 not only established more definitive guidelines on per-share presentations; it also provided standards for the classification of securities whose nominal labels were not descriptive of their true substance.

The evolution of the accounting profession's thinking on the matter of presentation of per-share data principally reflects an increasing awareness that, whether accountants like it or not, the business community places considerable reliance on earnings-per-share data. Rather than continue to debate the propriety of this, the profession accepted the responsibility of establishing relatively uniform standards so that per-share data would be calculated in a similar manner by all companies. From the accounting profession's point of view it is unfortunate that Opinion No. 15 was not issued a year or two earlier, in advance of the increasing criticism leveled at per-share presentations in 1968 and 1969.

On the other hand, one must also question whether Opinion No. 15 meets adequately the profession's responsibility in this area. To present only an amount for primary earnings-per-share on financial statements for companies with several complex securities outstanding when there are so many ways this amount could be arrived at fails to provide proper communication to shareholders. A footnote explanation should also be required to show the method by which the per-share amounts were calculated. With such an explanatory footnote the per-share data would be communicated to investors in an understandable manner.

### 3. *APB Statement No. 3*

This statement, issued in June 1969, is the culmination of research and APB deliberation covering nearly ten years. The Statement explains the effects on business enterprises and their financial statements of changes in the general purchasing power of money, describes in a general way the nature of financial statements restated for general price-level changes, and provides guidance on how to prepare and present such statements. The APB concluded that financial statements restated for the effects of general price-level changes present useful information not available from conventional financial statements. The APB further concluded that general price-

level information is not required at this time for fair presentation of financial position and results of operations, even though the data are useful.

Thus, in Statement No. 3 the APB took a tentative, but significant, step which may lead to an eventual requirement to present financial statements restated for the effects of general price-level changes. At the present time, companies may elect or not to present restated financial statements. In time, such election may become a requirement. At that point one of the significant deficiencies in present accounting, the failure to account for the effects of inflation, will have been rectified.

The effects of general price-level changes, inflationary in nature for the past 30 years, are embodied in the financial statements of all companies. Unfortunately, even a reasonable review of a set of financial statements will not permit one to estimate with much accuracy how the statements would differ if restated for inflation's effects. The absence of restatement means income is overstated, on the one hand, if the company is in a capital intensive industry, since costs of using plant and equipment are expressed in older dollars. On the other hand, inflation is advantageous for those companies which have heavy fixed dollar obligations, and conventional accounting fails to recognize this effect of inflation.

The attention focused on the accounting profession's failure to recognize the effects of inflation in the last year or so has been stimulated by the increased inflationary rate in this country and by the general criticism of conglomerates and their accounting practices. As noted earlier, the deficiency in accounting on the matter of dealing with inflationary effects runs to all business and not just to conglomerates. However, if one company acquires another at a price which recognizes the current values of that company's assets, but is permitted to account for those assets at their book values for the acquired company, the acquiring company is put in the position of being able to report income from the sale of those assets. In reality, the income is a recovery of cost to the acquirer.

Any company having assets whose book values do not reflect present price levels can generate "income" in this manner. The criticisms of conglomerates on this issue should really be a criticism of the accounting profession for permitting such a situation to exist. Statement No. 3 falls short of eliminating this deficiency, but hopefully is a first step in its eventual elimination.

At some point the accounting profession must accept the responsibility of communicating the consequences of changes in the general price level to financial statements users. Statement No. 3 provides one possible approach — the substitution of the price level adjusted statements for the traditionally-based cost statements. However, fair financial statement presentation might better be achieved by requiring price level financial statements to be presented in parallel columns with the cost statements.

## ACCOUNTING FOR BUSINESS COMBINATIONS AND GOODWILL

When the Accounting Principles Board was formed in 1959 one of the most pressing issues facing it was clarification of the principles governing the accounting for business combinations. In the intervening years the American Institute of Certified Public Accountants has published two research studies relating to this problem. The first, *A Critical Study of Accounting for Business Combinations*, by Arthur R. Wyatt, was published as *Accounting Research Study No. 5* in 1963. The second, *Accounting for Goodwill*, by George R. Catlett and Norman O. Olson, was published as *Accounting Research Study No. 10* in 1968. Prior to publication of the latter study the APB began intensive debate designed to lead to an eventual APB opinion on these topics.

The 1963 study dealt primarily with whether both the pooling-of-interests and purchase methods of accounting were appropriate to the reporting of business combinations. The study concluded that business combinations are essentially exchange transactions whether the consideration is in cash or securities and that pooling of interests is neither sound in concept nor an informative or appropriate method of recording the exchange. It recommended that purchase accounting be used for all business combinations involving independent entities. Consideration of this recommendation and others made in the study by the APB was delayed pending a study of the problem of accounting for goodwill, a problem which would become much more acute if pooling accounting were eliminated.

The 1968 study also concluded that pooling of interests was not an appropriate method of accounting and that purchase accounting should be used for all transactions involving independent entities. This study gave extensive consideration to the nature and characteristics of goodwill. It concluded that the proper method of accounting for goodwill, after current valuation of all acquired separable resources and property rights, is to deduct goodwill from stockholders' equity, either by a charge to capital surplus or retained earnings or by showing a deduction for goodwill on the face of the balance sheet.

The extensive research, discussion and debate in these problem areas are indicative of the complex matters involved. One finds that in facing up to these problems he is confronted with several long-standing accounting deficiencies, deficiencies which existed in accounting long before the conglomerate method of merger fell into disrepute—actually long before the conglomerate method of merger gained identification. Certain aspects of these deficiencies mandate further elaboration.

*Pooling Is a Fiction*

Pooling accounting first appeared in the 1940's, and the concept was first officially authorized by the AICPA in 1950.<sup>12</sup> Prior to this develop-

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<sup>12</sup> AICPA, ARB No. 43 (1950).

ment, business combinations were accounted for under purchase accounting concepts whereby the acquiring company accounts for that which it acquires either at the fair value of the consideration given or the fair value of the assets acquired, whichever is more clearly evident. Mergers effected up to this point commonly caused little accounting difficulty. Values transferred in exchange were relatively closer to book values than is true today (inflation had had a lesser effect and stock market earnings multiples were much lower). Further, mergers were made in such a way that no goodwill (intangibles) arose, or if it did arise, existing accounting principles permitted a write-off of goodwill to surplus. The write-off was permitted, not because goodwill had lost its value, but because carrying forward the amount on the balance sheet was not a fair representation of the goodwill value of any company.

On January 20, 1945, the SEC issued its *Accounting Series Release No. 50*,<sup>13</sup> stipulating that thereafter no goodwill could be written off to capital surplus. Coincidentally, the pooling concept began to evolve. Under this concept, book values of the acquired company in a merger were carried forward and no goodwill was recognized. While the effect, insofar as goodwill was concerned, was the same as the previously unacceptable immediate write-off to capital surplus, both the accounting profession and the SEC accepted the concept. Thereby, the recognition of goodwill on the balance sheet was avoided.

However, the pooling concept was basically fictional. In effect, it asserted that the business combination event lacked substance sufficient to warrant the use of values established in the combination transaction as a basis for accountability. Pooling accounting assumes that the two companies have always been together, even though this assumption is acknowledged to be contrary to the facts. Acceptance of the fiction of always having been together provides the basis for other fictions. Thus, previously reported financial data of the separate companies are pooled together under the name of the surviving company and presented to the public as the historical record of that surviving company. Certainly, perpetuation of such a fiction can only be confusing to financial statement users. Further, the fictional assumption that the two companies have always been together permits acquisitions made subsequent to the annual report date to be included in reported earnings for the prior reporting period. The result achieved is contrary to the facts, buries the record of how the acquirer performed alone, and permits a window-dressing of earnings reports that is misleading as well as confusing.

If one were to trace the evolution of the pooling concept he would find an ever-widening fictional structure which evolved gradually from the initial assumption that the two companies have always been together. However, in recent years a wide range of artificial barriers (called criteria in accounting parlance) have been developed in an effort to restrict appli-

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<sup>13</sup> SEC, Accounting Series Release No. 50 (1945).



cation of the pooling method in situations in which the facts obviously indicate a purchase occurred. The artificiality of most of the criteria and a gradual recognition that many of the criteria are contradictory of the pooling concept have resulted in an increasing level of criticism of the pooling practice. The more knowledgeable one becomes about the pooling concept the greater is his awareness of its fictional aspects and the resulting distortion it produces in financial reports.

#### *Restriction on Trading of Shares Issued*

The criterion developed to restrict the trading of shares issued in a pooling combination provides an example of how a criterion, designed to guide accounting for a combination, may have effects far beyond the realm of accounting. During the 1960's the SEC established a policy of requiring recipients of shares issued in a business combination to retain those shares for a period of time in order for the combination to be accounted for as a pooling of interests. Specifically, the limits established and in effect during 1969 for permissible disposal of shares received were set at 25 percent in the first year after combination, 25 percent in the second year, with no restriction thereafter. More stringent restrictions had been in effect earlier. The accounting profession did not have such a criterion in its literature, although in practice the rules of the SEC governed accounting methodology.

The effect of this restriction may be demonstrated by the following example. Assume Company *A* has a million common shares outstanding of which, say, 60 percent is held by management, mutual funds, pension funds, *etc.*, and an additional 20 percent is held by "long-term investors" and, therefore, is not available for trading in a practical sense. After due deliberation, Company *A* effects a combination with Company *B* by exchanging 240,000 shares of its unissued stock for all of Company *B*'s stock. Whereas prior to combination about 20 percent of the shares was available to provide a market for the stock, after the combination, with restrictions on the shares issued, only 200,000 of 1,240,000 shares, or 16 percent of shares outstanding is available to provide a market. This narrowing of the market may provide support for, or enhancement of, the market price of the stock.

Further, Company *A* could have reacquired a portion of its own shares prior to the combination with Company *B*. If these reacquired (treasury) shares were used in the combination, Company *A* would reduce the number of unissued shares it would have to add to those then outstanding and thereby reduce any dilution or add to any enhancement in earnings-per-share. Assuming Company *A* could reacquire 50,000 shares for this purpose, the reacquisition would not only reduce the shares available to provide a market to less than 13 percent (150,000 of 1,190,000 shares outstanding), but it would additionally bolster the market for Company *A* stock.

While the above hypothetical is an extreme example, the principal issue is clear. The artificial rule restricting trading of shares issued in a combination to be accounted for as a pooling narrows the trading market for the shares. A higher trading price is the likely result, thereby making Company *A* stock even more valuable to use in subsequent combinations. The cycle can go on for a considerable period before the restriction time for trading passes and the combination shares add to the market supply. The result is curious at best: an SEC accounting rule designed to assist in policing a fictional accounting concept ends up providing stimulus to the merger fever in an artificial way.

### *The "Historical-Cost" Hang-up*

Adherents of the pooling concept latched on to one of accounting's most hallowed traditions for support — consistency with "historical cost." Reliance on historical cost in accounting had its genesis in feudal times and is continually nurtured by independent auditors and the comfort they seek from objective information. Historical cost is the measure of exchange value at the time a transaction occurs. Thus, when an asset is acquired, its value in exchange becomes its cost. Such an amount can be objectively verified and in the accounting records becomes the "proxy" for the asset itself. That is, the cost in dollars becomes the significant aspect of the asset acquired. With a few exceptions, generally grounded in conservatism, this cost remains associated with the asset as long as the asset remains in the enterprise.

Advocates of the pooling concept support their position, in part, by asserting that the bringing forward of book values preserves the historical-cost basis of the assets obtained in the combination. In this way, the argument runs, accounting following a pooling is consistent with what it would have been absent the pooling. The conclusion drawn is that pooling accounting is, therefore, consistent with historical cost. This, of course, proves its propriety since no sound accountant could ever fail to support historical cost.

This line of reasoning is wholly fallacious. Followed to its logical conclusion, it would mean, for example, that any company owning land in Manhattan Island should be carrying this land on its balance sheet at some portion of the \$24 allegedly paid to the Indians for the property. Only then would historical cost be preserved.

An integral part of the historical-cost concept in accounting relates to the accounting entity incurring the cost. Thus, each time an asset crosses entity lines in an arm's-length transaction a new cost is established. When one acquires a new car from General Motors the significant value is cost to the acquirer, not cost to General Motors. Under pooling accounting, however, when one acquires a group of assets from X Company, the significant value for the acquirer becomes the cost to X Company. This is a flat distor-

tion of the historical-cost concept. The result for the acquirer in most cases in the 1960's was a "secret reserve" immediately upon acquisition — an unrecorded excess of fair value over recorded balance sheet value — and an opportunity for "instant profits" whenever the acquirer decided to take down all or a portion of his "secret reserve".

Thus, a conglomerate — or any other acquiring company — can seek out a company with undervalued (in current terms) assets, issue shares of common stock to acquire the company, follow pooling accounting and bring forward the book values of the company acquired, sell all or part of the assets, and pick up the gain in its income statement. Some have likened this sequence of events to a sale of stock for cash with a reporting of the proceeds as income. Neither the accountants nor the SEC would permit the latter sequence, but both permit — even endorse — the pooling sequence even though the results are identical.

### *Disregard of Inflation*

An earlier section considered the general deficiency in present accounting practice relating to the disregard of the effects of inflation. While disregard of inflation cannot be attributed to the pooling concept, that concept does perpetuate this deficiency. Normally when assets are acquired by a new purchaser the past disregard of inflationary effects on those assets is rectified. The buyer records the assets at their fair value on the date of acquisition, a value which includes the effect which inflation has had on those assets while in the hands of the seller. Likewise, the seller receives consideration which compensates him for inflation's effects on the assets sold, although the seller would report those effects as a gain or loss (usually as an unidentified part of the net gain or loss on the sale).

Since pooling accounting brings forward acquired assets at book value, any effects of inflation on these assets during their life are ignored, just as they would be under present accounting had the assets not been sold. Whether the merger event should be the vehicle by which partial recognition should be given to certain effects of inflation is debatable and is not the central issue in any event. The merger results in a direct confrontation by accountants with this long-standing deficiency, and accountants walk away from the confrontation when pooling accounting is used. The result of this is somewhat insidious — not only is an opportunity lost to attack head-on one of the most significant deficiencies of present-day accounting, but that deficiency is permitted to become even more deeply entrenched in the practices of the day.

### *Inadequacies in Accounting for Asset Costs*

A parallel situation exists regarding the deficiencies in present accounting for asset costs, considered at greater length in an earlier section. Since pooling accounting carries forward existing book values of the acquired company, any inadequacies in accounting for the assets of that

company are perpetuated. If the acquiring company then sells off all or a portion of the assets acquired, realizing thereby an "instant profit," critics are quick to blame the acquirer (sometimes a conglomerate) for engaging in an abusive practice.

As noted earlier, the true source of the abuse is the inadequate accounting for assets. Pooling accounting is merely an accessory after the fact. Should the merger transaction be the event which triggers the correction of the prior inadequate accounting? This issue is under debate by the Accounting Principles Board currently and a solution is expected by mid-1970. Regardless of the decision reached by the APB, only the tip of the iceberg will have been considered. Should the pooling concept be preserved to any significant extent, the confrontation with the problem of proper accounting for the costs of assets will once again have been postponed. If the pooling concept is not preserved, the imminence of confrontation will be escalated. The real problem, however, will remain.

Both pooling accounting and the conglomerates have borne criticism which rightfully belongs to the inadequacies of accounting for asset costs — pooling accounting because it perpetuates the inadequacies, the conglomerates because they take advantage of them. The only way to silence the criticisms is to eliminate the deficiencies in a direct and forthright manner.

### *Misunderstanding of Goodwill*

Pooling accounting is so interwoven with goodwill that the problems in one area require full consideration of the other. "Goodwill" is a term used in accounting in a variety of ways and with several meanings. In fact, sloppiness in the use of the term is so prevalent that discussions of goodwill become overly confused because the discussants do not have similar concepts of the topic. The difference between the current value of a business as a going concern and the current value of the various items of producing property is attributable to intangibles, including goodwill. Other aspects of the intangibles include management capabilities; location advantages; personnel training and development advantages; product research, development, timing and advertising preferences, *etc.*

Goodwill really relates to the demand and confidence of consumers in a particular product, company, or management. Too often the term "goodwill" is used when a more accurate reference would be to "intangibles" broadly. Investors, who establish the aggregate value for a company, do not bother to separate all the factors which influence their judgments as to the value of a company. Accountants, unfortunately, have tried to isolate one piece of the unidentified intangibles to call goodwill; and the result has been continuing confusion over the real nature of goodwill. In the following discussion "goodwill" is used to mean the aggregate of all the intangible factors which create the difference between the total value of a business and the value of its identifiable resources and property rights.

Prior to the birth of poolings in the mid-1940's, goodwill (in the sense

of unidentified intangibles) was eliminated from corporate balance sheets as early as possible. In some cases the amount was written off when it arose. As the SEC exerted increasing pressure against this practice, some companies continued to carry goodwill as an asset for a few years and then wrote it off in a lump sum. Other companies disposed of their intangible balances by amortizing the amount to income after it was recorded. Some companies merely carried the balance forward as an asset.

Most financial statement users intuitively reject goodwill as an asset comparable to other assets on the balance sheet and thus eliminate it in their analyses. Pooling accounting, which eliminates goodwill by giving it no recognition, was readily accepted by those who wanted rapid disposition of goodwill amounts. As the use of pooling accounting expanded, increasing amounts of "goodwill" that would otherwise have been recorded under existing accounting principles were not recognized on corporate balance sheets.

The heart of the matter is a lack of understanding that goodwill is not an acceptable asset for financial statements. If it were an acceptable asset, certainly all the goodwill (intangibles) of a corporation should be reported. This would mean that at each reporting date each corporation would have to attempt to measure its goodwill for inclusion in its financial statements. But, it is not the corporation that determines its goodwill. Rather, investors, those who use financial statements, make determinations of goodwill values. By the time financial statements reach investors, goodwill values can be significantly different from those at the reporting date. Further, absurd circularity is introduced if goodwill values are inserted in financial statements which investors use to help them determine those goodwill values.

Recognition of only part of a company's goodwill, such as would result from a business combination under purchase accounting, is equally illogical. The corporate balance sheet would henceforth report an amount for goodwill which (1) represents only a portion of the corporation's goodwill, and (2) arose at some earlier date, a date no longer of particular relevance to current financial reports. Goodwill has never been a suitable asset for inclusion in a balance sheet, and it is not today. While pooling accounting leads to the right result as far as goodwill is concerned, it does so by ignoring goodwill and it results in a coincidental ignoring of all asset values relating to the acquired company in the combination.

#### A COMPLEX DILEMMA — IS THERE AN ANSWER?

The merger activity of the 1960's, in which the conglomerates were active, but by no means the only participants, accelerated recognition of many defects in accounting. The complexity of the merger event, with all its attendant negotiations and wide-ranging considerations, also highlights certain accounting complexities. Values exchanged in merger trans-

actions vary greatly, in many cases, from the values reported in financial statements by the companies involved. The merger event itself is not responsible for this variance. Accounting deficiencies are the cause of a significant portion of the variance in many instances.

A matter which should be more disturbing to accountants, however, is a gradual recognition that not only the financial statements of the acquired company are deficient. The acquiring company's statements may be equally deficient. These deficiencies are perpetuated under pooling accounting, and this result of pooling may well be the most distressing of all to accountants. Twenty-five years of pooling accounting has led to delays in attacking the basic issues, excuses for not facing up to overriding accounting principles and objectives, and even today to strong efforts within the profession for a continuation of the pooling fiction.

Some say there is no answer, that accountants are incapable of coping with the complexities involved. These people would stand pat with current practice, maybe with a few patches at points of highest tension, apparently with the hope that their own retirement would precede the actual demise of the profession. Others insist that answers can be found, and in fact must be found.

The deterioration of merger accounting, and the resultant criticism of accountants and conglomerators which it has spawned, focuses more clearly than ever on an overriding need in accounting—to establish objectives for accounting and financial statement presentation to support sound accounting principles. If financial statements serve any purpose other than as a record of last year's score, that purpose is surely that of a communication vehicle for consideration in a variety of business and economic decisions. Principles must be honed which will make financial statements as useful as possible for such decisions, and these principles must take a new look at accounting for the costs of developing and enhancing corporate assets. The ultraconservatism of the past cannot survive if the end product is to have usefulness.

#### SHOULD A MERGER TRIGGER CORRECTION OF EXISTING ACCOUNTING DEFICIENCIES?

Careful study of the nature of business combinations, as well as current accounting practices for them, provides several sensible answers:

(1) Most business combinations are in fact purchases of one company by another. While a high degree of pooling, or integration, may be given lip service during negotiations, the dominant constituent is generally evident and its dominance soon is asserted.

(2) Purchase accounting concepts are clearly more consistent with accounting practices generally than are pooling concepts. Pooling accounting results in carrying forward outdated values through a denial of the economic consequences of the transaction. Purchase accounting establishes an accountability base point and best reflects the values of assets involved in the transaction.

(3) Pooling accounting is artificial and in practice the criteria for its application have deteriorated so badly that a cloud exists over the entire concept. Since it is fictional at its base, distortions in application are virtually a certainty.

However clear a solution is to the purchase versus pooling controversy, the fact remains that the results of purchase accounting raise further significant questions. Should the merger transaction be the vehicle for a partial correction of past disregard of inflation? Should the merger transaction provide an instant correction for the past deficiencies in accounting for the cost of assets? What about the acquiring company's assets — generally even more significant than the acquired's — how can similar corrections be effected? Even if the latter corrections were effected, what about the hundreds of companies that do not engage in mergers? How can the deficiencies of current accounting be corrected for them?

Answers to these questions continue to be debated within the Accounting Principles Board. Agreement is difficult because each Board member starts from a different base point as to the purposes and objectives of financial statements. However, accountants and conglomerators alike should demand the abolition of the ill-conceived pooling concept. It was fictional in its inception and has been distorted in application. The cloud it casts over merger accounting must be removed.

On the other hand, common sense indicates that a company's decision to merge with another is inadequate justification to effect a one-time correction for the accounting of the acquired company. Purchase accounting must be the underlying concept, but certain temporary delays in effecting piecemeal corrections should be provided until the causes of accounting defects can be attacked in a forthright manner. Book values of certain assets should be permitted to be carried forward, not because of an artificial pooling concept, but because the accountants have not been timely in their development of sound accounting principles for such assets. Under this approach pressure for real corrective action would be increased; continuation of pooling eliminates all such pressure.

#### WHAT ABOUT INTANGIBLES?

Whereas the deficiencies noted previously have caused substantial embarrassment for accountants and conglomerators alike, the accounting for intangibles, including goodwill, under pooling accounting (really a non-accounting) has been free of criticism. No one seems concerned about the virtual absence of goodwill from corporate balance sheets — accountants, conglomerators, nonconglomerate business managers, stockholders, or other statement users. Even so, the result obtained for goodwill from pooling accounting hardly justifies continuation of poolings. The matter of goodwill should be resolved frontally and not by subversion.

Simply stated, goodwill is an asset basically different in nature from other assets. For many businesses it may be the most valuable asset to the

investor, but the balance sheet cannot be expected to inform the investor about the goodwill. Investors in the aggregate determine the goodwill of a company, and such determination does not rely on the balance sheet reporting of goodwill. The cost of purchased goodwill has no continuing and reliable relationship to its value. Goodwill is not the type of asset that belongs on the balance sheet.

Another common "hang-up" in the accounting profession on goodwill concerns the demand that purchased goodwill be amortized by charges to the income statement. This conclusion fails to recognize that goodwill is not utilized or consumed in the production of earnings. It has no discernible or predictable life. It may live in virtual perpetuity, it may disappear overnight, or it may multiply manifold as time goes by, rather than be diminished. A conclusion to amortize goodwill by charges to income must be based on establishing an arbitrary time period. In many cases the result would be amortization by a charge to income while goodwill actually increased in value during the period.

While this latter result is an absurdity, a final decision to eliminate goodwill from the balance sheet and bar its amortization to income must rest on a more thorough understanding of the nature of goodwill. The marketplace determines the value of goodwill; bookkeeping entries may change the book amount, but marketplace determination will be made irrespective of the bookkeeping. However, if the meaningless bookkeeping is misleading, marketplace confusion will result. Amortization of goodwill to income distorts income, misleads users and should be prohibited by the accounting profession and the Securities and Exchange Commission.

#### CONCLUSION

Most observers would likely conclude today that accounting principles have had more effect on conglomerate growth than the reverse. Certainly, the bandwagon critics of both phenomena of contemporary business foster this relationship. The fact is, of course, that accounting principles applicable to conglomerates are no different from those applicable to the wide range of nonconglomerate businesses.

In due time realization may come that conglomerate growth has had a pronounced effect on accounting principles. Signs appear here and there that accountants are becoming more sensitive to their critics, more inclined to seek sound answers than to patch the previous patches. Conglomerate growth has required accountants to focus on important issues — inflationary effects, inadequate accounting for asset costs, the fictions of pooling-of-interests accounting, and the unique nature of goodwill. The confrontation with these issues has been avoided by accountants to date, but sooner or later retreat will be impossible. If the conglomerates have hastened the day of meaningful attack on longstanding accounting deficiencies, the critics of both accountants and conglomerators may soon be stilled.