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ACCOUNTING PRACTICES AND THE MERGER MOVEMENT

*Abraham J. Briloff**

Introduction

The decade of the 1960s may well be remembered by future historians of the American scene as the "Decade of the Twin Congs" — the Viet Cong on the one hand, Conglomerates on the other. That this is not a mere rhetorical conceit might well be attested to by the fact that the mention of either invariably generates intense emotion; also, the actions of the conglomerators are all too frequently analogized with those of the Viet Cong, what with their infiltration, facelessness, anonymity, the subversion and fear that they are capable of interjecting into the traditional corporate society, and so forth.

In any event, and fortunately for myself, my responsibility and expertise are limited to the conglomerates, and even then to the accounting roots and branches of that phenomenon of the sixties.

I. The Corporate Environment and the Accounting Function

Before proceeding to an in-depth deliberation of the accounting framework of conglomerates, let us consider briefly several parameters of the corporate society that have particular bearing on the accounting process. This brief overview is necessary if we are to achieve a better understanding of the objectives of the accounting practices and procedures that have been adopted by conglomerates.

To begin with, we must be made mindful of the Power vs. Property dichotomy existing in our corporate society. This essential juxtaposition of professional management and shareholders was discerned by Professors Berle and Means,¹ and has been most recently, effectively, and extensively described by Professors Berle² and Galbraith.³ Thus, the professional managers' objectives do not necessarily parallel those of the corporation's shareholders; the managers have objectives that vary from time to time and are frequently dependent upon whether the corporation is a "mature" enterprise already "in orbit" or whether it is still in the process of acceleration on its trajectory towards its zenith.

In this polarized environment the shareholders do not enjoy ready access to the economic data relating to their corporation. Instead, they must rely upon the corporate management to discharge its responsibility of accountability — within the standards set by the Securities and Exchange Commission (and in some instances by other regulatory bodies) and by the American Institute of

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This article is based upon testimony delivered by Professor Briloff before the Senate Subcommittee on Antitrust and Monopoly in Washington, D.C., on February 5, 1970.

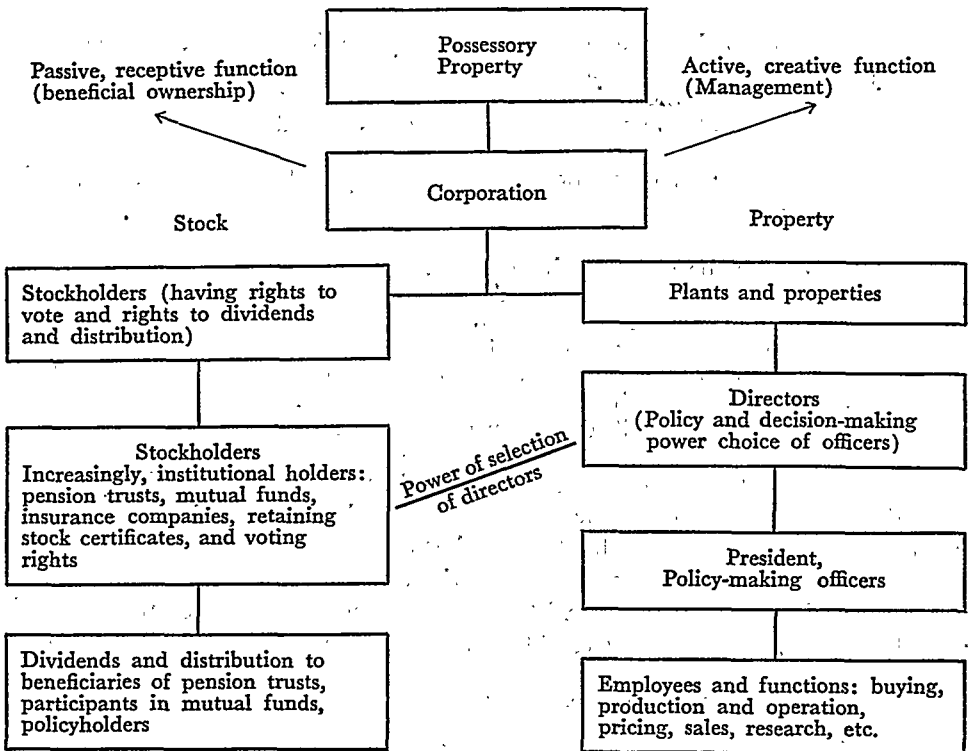
¹ See A. A. BERLE, JR. & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

Certified Public Accountants [AICPA]. Presumably, the discharge of this responsibility is effected in accordance with generally accepted accounting principles [GAAP]; and the independent auditors are assumed to attest to the satisfactory discharge of management's duty to account only after making the tests and verifications required by the book of rules known as generally accepted auditing standards. The culmination of this attestation function takes the form of the independent auditor's certificate or opinion.

Now, therein lies the rub. As we are all undoubtedly aware, GAAP is a rather amorphous, at least highly flexible, body of alternatives that were developed throughout the accounting profession's evolution by academicians, practitioners, advisers to government, and management. These principles find their way into the ambit of respectability sometimes through our professional literature and sometimes just because they are being applied in practice — first by the few, then copied by the many, and then the generality of the practice is accepted, whereupon it becomes a part of GAAP. As I review the evolutionary development of GAAP it appears that, almost without exception, new alternative principles and practices are absorbed over time without exorcising any of the

2 See A. A. BERLE, JR., *POWER WITHOUT PROPERTY* (1959). Schematically depicted, Professor Berle's conceptualization of the Power vs. Property schism appears as follows:

DIVISION OF PROPERTY AND POWER UNDER THE CORPORATE SYSTEM



3 See J. K. GALBRAITH, *THE NEW INDUSTRIAL STATE* (1967).

earlier practices previously in vogue, even after the antiquated practices were found defective or otherwise inadequate. In brief, there is no process of "natural selection" at work whereby that which has been found wanting is banned and proscribed. Instead, these deficient principles are fossilized but never categorically rejected.

It is also important that we understand somewhat more precisely the true nature of the independent auditor's responsibility — as contrasted with the prevailing myth; and it is especially important that we discern this distinction in the light of GAAP's flexibility and flabbiness. Thus, the prevailing myth on the part of the great mass of the tens of millions of American investors, and even of a majority of our sophisticated investors, and great numbers of our so-called professional investors, is that the auditor first distills the facts and the figures, then culls from the various GAAP alternatives those that would most fairly measure and reflect the truths of the corporation's economic activities, and thereupon promulgates his statements regarding the corporation "without let or hindrance." This is the myth we generally like the public to cherish; however beautiful and idyllic this myth may be, it diverges materially from the realities.

The truth is, as the AICPA's Committee on Accounting Procedure has made clear, that "[u]nderlying all committee opinions is the fact that the accounts of a company are primarily the responsibility of management."⁴

The implications of this categorical assertion have been described by Professor Dwight Ladd:

Given the profusion and confusion of "professionals" . . . it is not surprising that the real authority over accounting for corporations rests with those who have the ultimate power — the managements of the corporations whose status and progress are being accounted for.⁵

This condition was dramatically described by a leading certified public accountant as follows:

It might be well to point out . . . that the auditor is not required to state that the principles followed were proper or that, in his opinion, the financial statements give a fair presentation. Thus, it is possible that the individual auditor may actually believe that the statements are not fairly presented. Nevertheless, as long as the accounting practices followed by the company fall within the so-called "generally accepted accounting principles" an unqualified opinion may be rendered.⁶

Given the realities as they are, it follows that managerial proclivities, more than the auditor's idea of fairness and the "truth," will very significantly and vitally affect the substance of the "certified" statements.

So it is that when it was the managerial objective to reduce income to an irreducible minimum (consistent with what was then deemed to be the "normal growth curve") accountants were able to accommodate management's "Twiggy-

⁴ ACCOUNTING PRINCIPLES BOARD, ACCOUNTING PRINCIPLES § 510.13 (1969) (Current Text as of August, 1969).

⁵ D. LADD, CONTEMPORARY CORPORATE ACCOUNTANCY AND THE PUBLIC 163 (1963).

⁶ Hennessy, *Unrealities in Accounting Reporting*, in PROCEEDINGS OF THE EIGHTH ANNUAL INSTITUTE ON ACCOUNTING 12 (1961).

figure" objectives by giving them LIFO inventories, accelerated depreciation, fast R&D and intangible write-offs, extraordinary pension cost charges, write-offs of oil company development costs, and the like. It was this pattern of value suppression that gave rise to the observation that a balance sheet was like a Bikini bathing suit — revealing the interesting, concealing the vital. In fact, it might be fairly asserted that it was this very traditional commitment to "a conservative balance sheet," low-earnings reporting, and high liquidity with low debt, that made life so simple for the flamboyant conglomerators, for the performance-oriented new breed of management determined to show flair, synergism, flash, and charisma.

And it is here that our GAAP, with its emphasis on "when was income realized" rather than under whose aegis were the values created — coupled with the pooling of interests alternative for accounting for takeovers, and the many other alternatives to be considered presently — permitted the new breed to "do their thing." In short, as will be demonstrated presently, all that the new management had to do was to expose that which had heretofore been kept from sight and Wall Street would eat it up.

II. The Dynamics of the Securities Markets

The "dynamics of Wall Street" relate closely to the ways that accounting principles and practices were utilized by the conglomerators in their acquisitive pursuits. As is generally known, the securities marketplace has been much affected by the so-called "P/E syndrome," by which is meant that securities are valued by applying to the company's earnings a certain multiple (the "P/E" ratio). The mystique of this price/earnings determination is something beyond the comprehension of most mortals. While recognizing that the factor varies from industry to industry and from time to time, one cannot identify by whom and by what method the determinations are effected. 'Adam Smith's' Gnome of Zurich might be the arbiter; it may also be that the P/E is a determinate rather than the determinant. In any event, it's there and a company's earnings are of primary (probably *the* primary) factor in the securities-price determination calculus.

If we add to this the fact that the marketplace is now importantly oriented towards "instant-earnings growth," as contrasted with looking to the long-range growth rates of earnings and to the earnings reliability, we can see how those accounting procedures capable of inducing instant-earnings spasms can have a most volatile impact on the current market price of a company's securities. As will be demonstrated, we have just such psychedelic procedures as part of our book of GAAP. This possibility of inducing a huge price appreciation for a security complements the acquisitive objectives of the company, since the securities they are capable of turning out (metaphorically as fast as a counterfeiter's press) have a correspondingly high value in the market place. A company upon whom the high priests of Wall Street are smiling (through their having assigned a high P/E to the inflated "E") is thereby capable of "zeroing-in" on a less felicitously endowed company whose management has traditionally em-

phasized the low "E" and has been assigned a more conventional low P/E ratio. And even if nothing else happened after the takeover, the very absorption of the target company's earnings into the acquisitive conglomerate adds to the market value of the latter company. This is because the ratios on the swap were determined by the relative premerger P/Es; on the takeover the psychedelic P/E becomes applicable to produce still higher market prices for the conglomerate even if the whole of the aggregate earnings are nought but the sum of the prior parts.

But in most cases the merger magic was even more dramatic since it included the "vigorish" derived from leverage, special series of preference shares, deferred conversion and/or contingent issuance provisions on the exchange, and the like. In brief, a great many vectors were introduced into the merger-magic calculus — all intended to induce still higher earnings per share for the conglomerate — and with each such injection the felicitous prophecy of the high priests, and their blessings on the conglomerators, are shown to have been fulfilled.

But the felicity does not stop there. When the new breed of managers moved into the fleshpot of assets nurtured by the traditional management, they were able to dispose of them at huge profits when compared with the vestigial written-down book values, thus producing still greater earnings exposures by the new management; and then when the new management relaxed the old Twiggys-accounting constraints, the reported earnings zoomed still more and the high priests of Wall Street were unqualifiedly certain that they had oracular powers approaching the divine. And this could, theoretically at least, have permitted the chain reaction to continue until all of our economic resources would have been brought within the ambit of the entity blessed with the highest P/E ratio.

This, then, is the turf on which the conglomerators play their accounting game. Let us now examine some of the more significant maneuvers or plays allowed in this game.

III. Accounting for Business Combinations

The principal controversy in the area of accounting for business combinations revolves about "pooling-of-interests accounting." The term was last officially defined in January, 1957, in *Accounting Research Bulletin Number 48: Business Combinations*,⁷ as:

A business combination of two or more corporations in which the holders of substantially all of the ownership interests [basically common stock] in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors . . . are present.

These "certain other factors" are then suggested by the *Bulletin* thus:

1. "After a pooling of interests, the net assets of all of the constituent corpo-

⁷ ACCOUNTING PRINCIPLES BOARD, ACCOUNTING PRINCIPLES §, 1091.01-.13 (1969) (Current Text as of August, 1969).

- rations will in a large number of cases be held by a single corporation," but there may be "important tax, legal, or economic reasons for maintaining the subsidiary relationship"
2. Purchases (rather than poolings) may be indicated by such attendant circumstances as:
 - a. "When the shares of stock . . . received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessor"
 - b. "[I]f relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities"
 - c. The existence of "a plan or firm intention and understanding to retire a substantial part of the stock issued to the owners of . . . the constituent corporations, or substantial changes in ownership . . . planned to occur shortly after the combination"
 - d. The "abandonment or sale of a large part of the business of one or more of the constituents"
 - e. "[I]f the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated."
 - f. While relative size is not necessarily determinative "especially where the smaller corporation contributes desired management personnel," there is, nevertheless, a presumption of a purchase (hence not a pooling) "where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 per cent to 95 per cent or more of the voting interest in the combined enterprise)"

The *Research Bulletin* counsels that the presence or absence of the factors should be viewed as a whole, that "[n]o one of the factors . . . would necessarily be determinative and any one factor might have varying degrees of significance in different cases." The *Bulletin* then sets forth the critical distinction between the accounting for the two alternatives. Where a combination is deemed to be a purchase, the properties acquired should be recorded on the books of the acquiring corporation "at cost, measured in money" or at the "fair value of . . . other consideration, or at the fair value of the property acquired, whichever is more clearly evident."

On the other hand a "pooling" triggers the following: "[A] new basis of accountability does not arise; instead, the carrying amounts of the assets of the constituent corporations . . . should be carried forward"

These, then, are the ground rules of the pooling-purchase choices available to the conglomerates. Clearly, the former is intended to accommodate all those marriages that were made in Heaven, where the two companies were destined from time immemorial to converge — except that fate had not yet disclosed its hand. As soon as the true destiny is revealed, however, one simply combines the two balance sheets, essentially just as they are, and then the combined operations go forth into a common future — supposedly retaining their existing managements, businesses, shareholder rosters, personnel, and the like. All busi-

ness combinations not fitting this blissful pattern are supposed to be accounted for as "purchases," meaning that the price paid by the acquiring entity first must be quantified. After the aggregate price is determined, then (according to the *Bulletin*) "the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money This is in accordance with the procedure applicable to accounting for purchase of assets."

Now that we have the distinction between the two alternatives clearly in mind, let us see just how they worked out as the game was played.

A. Dirty Pooling Exemplified

First, let us take a pooling situation that is now something of a classic, namely, the transactions whereby Gulf + Western Industries, Inc. [G+W] acquired a potpourri of going concerns, including Paramount Pictures Corporation, during G+W's fiscal year ended July 31, 1967.⁸ In exchange for control over the acquired companies, G+W parted with a bundle of securities (some common stock, but mostly preferred) worth about \$185 million at the time of issue. This appraisal notwithstanding, the accountants booked these acquisitions at about \$100 million, a figure equivalent to the book value of the acquired entities' net equity. In this fashion about \$85 million of G+W's costs never showed up in its accountings.⁹

But this is only where the fun and games really began, because immediately after getting control of Paramount the new owner (i.e., G+W) proceeded to generate what has since become known as "instant earnings." This it did by effecting a major disposition to television of a collection of Paramount's feature films (severely written down on its books), receiving in return installment contracts which G+W recognized as income in one fell swoop.¹⁰

Since this ploy generated huge amounts of revenue with very little cost, G+W's 1967 income statement blossomed beautifully — and Wall Street was delighted with the floral display. And the G+W management was able to assert, all in accordance with GAAP, that while tired old Paramount et al., had earned less than \$3 million the year before the takeovers, in the year immediately following their entry into the pool with G+W they were able to earn more than seven times that sum — over \$22 million. Clearly this is great going, producing an extrapolated P/E ratio which, when applied to the appreciably greater reported earnings, caused G+W to be dubbed a real glamour stock.

8 In addition to Paramount, G+W's acquisitions during the year were: South Puerto Rico Sugar Company, Taylor Forge Inc., North & Judd Manufacturing Company, Collyer Insulated Wire Company, and Desilu Productions Inc. G+W also purchased a majority interest in Hedman Mines Limited of Canada during the period. 1967 GULF + WESTERN INDUS., INC. ANN. REP. 4.

9 For a detailed discussion of G+W's financial legerdemain that gives credence to these assertions see Address by Professor Abraham J. Briloff, before The New York Society of Security Analysts, Jan. 10, 1968, in New York City, in FINANCIAL ANALYSTS J., March/April, 1968, at 71, 75-77. See also Burck, *The Merger Movement Rides High*, FORTUNE, Feb., 1969, at 79, 82, 158.

10 During fiscal 1967 alone Gulf + Western netted \$20 million by releasing thirty-two of Paramount's films to the American Broadcasting Corporation. See Brown, *Hollywood Rides Again*, FORTUNE, Nov., 1966, at 181. See also Ruckeyser, *Gulf & Western's Rambunctious "Conservatism,"* FORTUNE, March, 1968, at 122.

Overlooked was the fact that G+W was doing nothing more than stripping the top soil that had been so carefully nurtured by the traditional managements and proceeding to sell this fertile soil; and for doing this they were able to say (again consistent with GAAP) "What great guys are we." Is it any wonder that G+W has been deglamorized over the past year or two — when its acquisitive potential was somewhat frustrated and it did not have anything for an encore?

B. Polluted Purchase Exemplified

Having seen the way pooling works out in a classic, relatively simple case, let us see how the purchase play has been utilized by our conglomerators. Again we will first examine a relatively simple case, the one where in 1968 National General [NG] acquired all of the shares of the well-known publishing company, Grosset & Dunlap [GD]. NG's accountings tell us that: "The total cost was approximately \$49,215,000 . . . which was \$33,048,694 in excess of [GD's] net tangible assets at date of acquisition."¹¹ NG asserted that the acquisition was being accounted for as a "purchase" so that one might have expected that this \$33 million would have been sprinkled in compliance with what appears to be the explicit directive in *Bulletin 48*, namely, "in accordance with the procedure applicable to accounting for purchases of assets."

Logically, that \$49 million should have been allocated to the balances of cash and receivables (net of payables), with the overplus attributed to the pools of inventories, land, buildings, other fixed assets, and the like, based on their March, 1968, values. Then one might have expected an analysis would have been made of Grosset's copyrights relating to its 2,400 titles currently in print, in order to determine the fair values thereof, as well as of the Bantam operations, which Grosset owned. Similarly, the publisher's contracts with Book-of-the-Month and others should have been appraised and part of the purchase price attributed thereto.

It was for all this, and then some, that NG parted with \$49 million. Did it, then, in good faith move to the "telling of it like it is"? Of course not. That would have necessitated NG's charging the \$49 million to future operations, consistent with cost-revenue matching procedures so fundamental to the accounting process. Instead, NG merely carried over Grosset's old balance sheet (reflecting only \$16 million of net assets) into the consolidation and added the remainder (\$33 million) into an "excess of cost" account (read this as a euphemism for "goodwill").¹² There it will stay until management decides otherwise.

In short, excepting the fact National General has effected an additional credit to its capital account and a compensatory added debit to its goodwill account, it has done very little, if anything, different from what would have happened using "dirty pooling" accounting.

In retrospect NG was a piker, playing with only \$33 million — but it was a good start and paved the way for others to follow with the big money (for example, AMK when it acquired United Fruit).

¹¹ 1968 NAT'L GEN. CORP. ANN. REP. 26.

¹² *Id.*

AMK acquired about eighty percent of United Fruit, giving up some cash but mostly bonds and stock — a total of over \$630 million. Of this amount it charged \$286 million to the net assets deemed taken over from United and charged the remainder, over a third of a billion dollars (\$344,215,000), to a goodwill account. (Here it was labeled “Excess of cost of investments over net assets at dates of acquisition.”)¹³ AMK knew that this was not really playing the game by the rules. Its July, 1969, prospectus tells us that: “A study will be undertaken to determine whether any portion of the excess cost of the United investment will be allocated to specific assets acquired or liabilities assumed. Such an allocation if made to depreciable assets, may materially reduce . . . net income.”¹⁴

AMK knows what it is supposed to do, but is it doing it? As late as mid-April of this year, AMK was still carrying this entire blob in goodwill; in the meantime it is issuing quarterly statements picking up United Fruit’s “profit contribution” at the rate of more than \$2 million monthly as part of the AMK consolidation.¹⁵ AMK must know this to be counterfeit coin since the sprinkling of the \$344,215,000 to United’s underlying assets would have added very appreciable amounts to the interim cost data with a corresponding suppression to the reported income. One cannot be certain as to whether AMK’s auditors will accept this income-inflation process when they audit their statements at year-end — but if the NG auditors went along with their determination, then why not AMK’s?¹⁶

What has happened then, is that we might have expected an invidious distinction between pooling and purchase accounting (a distinction favoring the

13 AMK CORP., PROSPECTUS, July 2, 1969, at 8.

14 *Id.* at 6.

16 AMK’s 1969 Annual Report, complete with eighteen separate notes to the company’s financial statements, was published in May of this year. Not surprisingly (considering the inordinate delay in releasing the Report), the Opinion of Independent Accountants appended to AMK’s financial statements is far more discursive than the typical short-form opinion. The second paragraph thereof informs us that:

The cost of AMK Corporation’s investment in United Fruit Company amounting to \$630,708,000 exceeds AMK Corporation’s interest in the net assets of United Fruit Company as shown in its accounts by \$344,446,000. . . . AMK Corporation has undertaken a study to allocate the recorded amount of its investment to the specific assets acquired and liabilities assumed. This study, representing a major undertaking, was commenced in 1969 and is not expected to be completed before late 1970. Until this study is complete the Company cannot determine what effect such an allocation might have on the accompanying financial statements.

The Opinion then points up some other misgivings (regarding plant closings and the receipt of notice from the Federal Trade Commission “to the effect that the Commission has decided to institute a proceeding to compel AMK Corporation to divest itself of . . . United Fruit Company . . .”) and moves to the formal expression of the auditor’s Opinion:

In our opinion . . . and (a) subject to the possible effect of the ultimate allocation of the \$630,708,000 cost of AMK Corporation’s investment in United Fruit Company [as well as several other “subject to” misgivings], the accompanying financial statements present fairly the consolidated financial position of AMK Corporation and its subsidiaries at December 31, 1969, the results of their operations . . . for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Clearly, while the auditors would not grant their *nil obstat*, they did permit AMK’s statements to carry their *imprimatur*. By this ambivalence AMK was able to reflect some \$22 million of United Fruit’s earnings in the consolidated income statement—a sum representing seventy percent of the consolidated income—without abatement for any portion of the \$344,446,000 charged to “Excess of Cost of Investments Over Equity in Net Assets of Subsidiary Companies at Dates of Acquisition.” We will, then, have to wait another year (or major fraction thereof) before we get the ultimate answer to this \$344 million riddle.

latter); as it has turned out their "polluted purchase" accounting has joined forces with "dirty pooling." In fact if they play the game right, they can get a "bigger bang" out of purchase accounting than pooling. This follows from the fact that the SEC now requires a retroactive restatement of prior years' statements after pooling (consistent with the underlying rationale for that accounting method) thereby reducing the year-to-year comparative dynamics.¹⁷ Purchase accounting, on the other hand, doesn't call for such restatement, so that AMK, for example, can say with a straight face in its last interim report: "We are pleased to report income of \$26,004,000 for the twelve months ended October 31, 1969 . . . as compared to \$11,166,000 for the 1968 fiscal year . . ." ¹⁸ Of course, we can perceive that this geometric rate of growth comes from United's contribution — but as management made explicit, the growth, however specious in amount and nature it may have been, was a source of pleasure.

C. The Part-Pooling, Part-Purchase Hybrid

The story of the alternatives of accounting for business combinations would not be complete without at least some brief reference to a hybridizing experiment that is not even referred to in the *Bulletin*. This breeding experiment produced the "part-purchase, part-pooling" mutation — it may be exemplified by the way in which Ling-Temco-Vought [LTV] carried on its accounting for the acquisition of old Wilson & Co. Here LTV bought fifty-three percent of Wilson for cash, and subsequently acquired the remaining interest through a statutory merger. It accounted for the cash portion as a purchase; the remainder was "put into the pool." Again, there is no logical or theoretical justification for the maneuver — they just did it. But it probably matters little since the end result was the carrying over to LTV of nothing but old Wilson's vestigial book values. This result prevailed because, on the purchase portion, the \$23 million in cash that LTV paid in excess over fifty-three percent of the old book values was stashed away in LTV's goodwill account,¹⁹ and the \$65 million excess actually paid as goodwill on the stock swap was completely and forever lost from sight (consistent with the suppression permitted by pooling). As a consequence, \$88 million paid by LTV to get at Wilson's operating assets will not wend its way into LTV's operating costs.

Then, to make things more interesting, when LTV stepped down old Wilson's assets into three new little Wilsons — Wilson & Co., Wilson Pharmaceutical, and Wilson Sporting (referred to by pundits as the "three balls" — "meat," "goof," and "golf," respectively) — the carrying values assigned after the disgorging were carved out of old Wilson's balance sheet so that even the \$23 million that had to be established stayed in LTV's sack. And most recently, when Meat Wilson was subdeployed into four new tiny Wilsons, the carrying values were correspondingly carved out of the vestigial costs — out of book-keeping costs going back for over a century.

¹⁷ See SEC Securities Act Release No. 4910; Exchange Act Release No. 8336 (June 18, 1968).

¹⁸ AMK CORP., FOURTH QUARTER REPORT, Oct. 31, 1969.

¹⁹ See 1967 LING-TEMCO-VOUGHT, INC. ANN. REP. 38.

Again, this process of suppressing the carrying values of the operating assets permits the acquiring entity to show lesser costs for its subsequent operating cycles. Perhaps an even more dramatic result is that the acquiring company is permitted to dispose of segments of these newly acquired assets and then to compute and report appreciable gains by reference to the depressed carrying values permitted by GAAP — although these gains would evaporate when the proceeds are compared with the amounts actually paid on the acquisition.²⁰ Again, these inordinate and artificial gains contributed importantly to the much-heralded synergism — the elixir of the conglomerate movement.

D. *Nunc Pro Tunc* Pooling

There is yet another accounting maneuver that our conglomerators found to be especially effective in their earnings-injection endeavors: I am here referring to the retrospective or *nunc pro tunc* pooling process. By this ploy, where the corporation completed its year with inadequate earnings its management was sent scurrying for new corporate acquisitions — it mattered little where they were located or what businesses they were involved in, just so long as they had earnings during the conglomerate's already closed fiscal year. In the meantime the conglomerate's statements were held in abeyance, frequently for an inordinate period of time.

Then, after the dragnet was successfully completed and the managerial option to pool duly noted by the auditors, the earnings of the newly acquired companies were merged into those of their new parent. The result sought and achieved was, of course, that once again management's promise of increased year-to-year earnings had been fulfilled.

One might have expected that in the wake of the Westec fiasco this particular finesse would have been banned absolutely. Our expectations notwithstanding, we still find manifestations of this procedure in recently promulgated statements, and they still carry the auditor's *imprimatur*.²¹

20 In this connection, we may ponder whether the pretax gain of approximately \$38 million that LTV has claimed on its sale of "Golf Ball" to PepsiCo, Inc. in February of 1970 would have been much reduced, if not eliminated altogether, had not the pooling-cost-suppression gimmick been employed by LTV. See 1969 LING-TEMCO-VOUGHT, INC. ANN. REP. 24; cf. Briloff, *The "Funny Money" Game*, FINANCIAL ANALYSTS J., May/June, 1969, at 73.

21 That the use of this gambit by management to "hypo" earnings (and keep its promise) may not have the desired effect of promoting investor confidence is well exemplified by the recent experience of National Student Marketing Corporation, "once the brightest star of the over the counter market." Following the close of its fiscal year on August 31, 1969, the corporation acquired eight companies and accounted for the acquisitions on the pooling of interests basis. The contribution to National Student Marketing's earnings made by the companies thus snagged by the dragnet was nearly \$3.8 million. When the investing public realized that this sum accounted for all of National Student Marketing's 1969 earnings of \$3.2 million and then some, a sellers' stampede of heroic proportions resulted. After reaching its 1969 high of \$71.50 on December 15, the value of National Student Marketing's stock dropped to an asked price of \$1.375 by May 13, 1970. See 1969 NATIONAL STUDENT MARKETING CORP. ANN. REP. 48; McClintick, *Bright Star Loses Luster*, The Wall Street Journal, March 12, 1970, at 28, cols. 1-3 (midwest ed.).

IV. Conglomerates and Insurance Companies — A Symbiotic Relationship

Having thus described the several alternatives for accounting for business combinations, those of “dirty pooling,” “polluted purchase,” and for want of a better descriptive term, the hybrid “jackass,” let me round out this phase of the discussion by summarizing the divergent practices pursued by three conglomerates in their accountings for their acquisitions of fire and casualty insurance companies. I will here describe the practices followed by Leasco Data Processing Equipment Corporation on its acquisition of the Reliance Insurance Company; by City Investing of Home Insurance; and by National General of Great American Insurance.

It is more than coincidence that the conglomerates directed their acquisitive bent towards these insurance companies. The conglomerates coveted the insurers’ huge pools of liquidity, their cash flow, and, as will be discerned presently, their latent pools of suppressed profits represented by the unrealized appreciation in their portfolios over the century or more of their respective security accumulations. There was, then, a symbiotic relationship formed between the conglomerates and insurance companies. Let us see how each of these three conglomerates has used or abused the accounting practices which have been alluded to.

A. Leasco — Reliance Insurance

First, the Leasco-Reliance accountings. In late summer of 1968, Leasco paid about \$400 million in cash, preferred stock, and warrants for Reliance; but, according to its books, this acquisition was assigned a cost of only \$171 million.²² Of course this suppression of almost a quarter of a billion dollars was feasible because Leasco opted for the pooling of interests alternative. Through this process Leasco’s consolidated statements picked up the Reliance common stock investment portfolio at its century-and-a-half accumulated basis of about \$111 million despite the facts that the value of the portfolio was about \$215 million at the time that Leasco moved in, and that Leasco was undoubtedly made to pay at least that much for the portfolio as a part of the \$400 million it paid on the Reliance acquisition. In any event, Leasco was able to acquire a potential for instant earnings of over \$100 million by carrying over the Reliance securities portfolio at its cost to Reliance, not its market value on the date that Reliance was absorbed.

Leasco had a most effective use for this latent pool; it injected more than \$24 million of the suppression into its 1969 fiscal year income statements as “Realized gains on investments of property and casualty companies”²³ — an injection equal to almost sixty percent of Leasco’s entire net income for the year. This would have been a most phenomenal performance — if only it were true. But it is not, at least as I see “the truth.” My view, of course, diverges from the way in which Leasco’s auditors see it: they certified their client’s performance records without exception or qualification.

22 MOODY’S INDUSTRIAL MANUAL, April, 1969, at 1147.

23 1969 LEASCO DATA PROCESSING EQUIP. Co. ANN. REP. 15.

As I see it, instead of this \$24 million profit, Leasco's statements should have actually shown an adverse consequence of almost \$58 million from their portfolio management during the year. I make this assertion because Reliance started its 1969 year (just about the time Leasco took over) with an unrealized appreciation of \$111 million, and by the end of that year the appreciation had shriveled to \$29 million — a deterioration of some \$82 million. Subtract from this the \$24 million in booked profits and you have what I consider to be a truer, fairer picture of the portfolio management last year, i.e., a loss of \$58 million.

What has Leasco done that the traditional Reliance Insurance managers would not have done? My answer is "plenty." First, the traditional managers would not have churned the portfolios just to create realized gains for improving the earnings statement, since it is only very recently that they have even permitted such gains to go into income.²⁴ Second, if the traditional management had reflected these gains they might at least have said that it was *their* investment acumen which created the gains in the first place; they made the investment decision to buy the securities at their original cost. Leasco management, as I have pointed out, took over the portfolio (paying the full late-1968 market prices therefor) but was permitted to pretend that these gains were its — again, because it pooled Reliance's accounts. Third, Leasco has a vested interest in creating these not-really-realized gains since it thereby forces Reliance to pay it, as the parent company, the hypothetical tax that would have been paid had Reliance stood all by itself. Because of Leasco's available write-offs and high tax bases, it will not actually have to pay these taxes to our government. These gains, then, produce an adverse cash flow for Reliance, but one which is salutary for Leasco. Fourth, the traditional insurance company man-

24 The following table, derived from Schedule D of the "Convention Reports" which insurance companies are required to file with the various state commissioners, demonstrates the dramatic rise in portfolio turnover rates that has occurred since the insurance companies that we are studying were absorbed by the conglomerates.

	Cost of Portfolio at Beginning of Year (a)	Securities Purchases During Year (b)	Cost of Securities Sold During Year (c)	Cost of Portfolio at End of Year (d)	Average Cost of Portfolio (a + d) ÷ 2 (e)	Ratio of Security Sales to Average Cost of Portfolio (c : e) (f)
<i>Reliance</i>						
1967	264	128	96	297	281	.34 : 1
1968	297	122	107	312	305	.35 : 1
1969	312	251	266	298	305	.87 : 1
<i>Home</i>						
1967	446	102	70	480	463	.15 : 1
1968	480	102	99	509	495	.20 : 1
1969	509	379	265	623	566	.47 : 1
<i>Great American</i>						
1967	274	72	61	278	276	.22 : 1
1968	278	205	173	309	293	.59 : 1
1969	285*	742	680**	354	320	2.13 : 1

* The cost of securities distributed as a special dividend to stockholders (principally National General) has been excluded.

** After excluding the amount shown by Convention Statement as a special dividend to stockholders.

agement would have husbanded its resources since it was bitterly aware of the implications of adverse market trends on vital reserves. It would not go about declaring extraordinary dividends like the \$39 million that Leasco induced Reliance to pay out last year.

All of these differences add up to a shrinkage in the insurance capacity of American insurance underwriters at a time when inflationary trends and the complexity of our technological society require even substantially greater reserves.

As historical digression, despite these and previous barbs at Leasco's accounting practices, I sincerely believe that our economic society owes Leasco an important debt of gratitude. As I see it, the financial community and our legislators generally first became acutely aware of the potential conglomerate menace when Leasco, flushed with victory after its Reliance coup, moved towards a takeover of one of the major New York banks.²⁵ It is now clear to all of us that the conglomerates are not satisfied to merely ride herd on tired old industrial managements, nor are they confined to knocking off small traditional entrepreneurs. When Leasco crossed the financial Rubicon the threat became abundantly clear. We are, of course, aware of the significant legislation in the tax realm that followed in the wake of this bold move, and to an important degree this very significantly slowed down the takeover wave.²⁶

B. City Investing — Home Insurance

I turn to the second of the conglomerate - insurance company tandems, City Investing's acquisition of Home Insurance.

In its 1968 prospectus on the exchange offer for Home shares, as well as by

²⁵ The abortive target was Chemical New York Corporation, parent of Chemical Bank New York Trust Company. At the time that Leasco made its takeover bid Chemical Bank had assets of approximately \$9 billion and ranked as the sixth largest bank in the nation. Following his rebuff from Chemical, Saul P. Steinberg, Leasco's chairman and chief executive officer, was asked if he had been under intense pressure from banking and investment sources to terminate his overtures. Replied Mr. Steinberg, "Let me just say that I'm bloody, but unbowed." *The Wall Street Journal*, Feb. 24, 1969, at 12, col. 3.

²⁶ See Tax Reform Act of 1969, tit. v, subtit. B, 1 U.S. CODE CONG. & AD. NEWS 652 (1969).

Leasco's fleeting courtship of Chemical Bank also evoked important legislation specifically designed to cool the conglomerates' ardor for banks. Rumors of Leasco's banking ambitions first surfaced on Thursday, February 6, 1969. Five days later, while the rumors were still presumably making the rounds in Wall Street corridors, it was reported that "The Nixon Administration is rushing work on a bill intended to prevent 'conglomerates' of big business and big banks from gaining control of the economy." *The Wall Street Journal*, Feb. 11, 1969, at 3, col. 1. See also *The Wall Street Journal*, Feb. 10, 1969, at 10, col. 4.

Legislation drafted to "end the movement of banks into non-banking enterprises" (and conglomerates into banking enterprises) was swift in forthcoming. Aligning himself with the Administration's view, Representative Wright Patman introduced H.R. 6778 before the House on February 17, 1969. The opening sentence of Mr. Patman's speech delivered when introducing the legislation fairly captures the thrust of the bill: "Mr. Speaker, today I am introducing a bill which seeks to stop the dangerous trend toward mixing the business of banking with all other businesses." 115 CONG. REC. H902 (daily ed. Feb. 17, 1969).

On March 24, 1969, H.R. 9385, the Nixon Administration's proposal, was introduced by Congressman Widnall. Congressman Widnall's sentiments mirrored those expressed earlier by Mr. Patman: "[T]he mixing of banking and commerce must be prohibited."

The Leasco-spurred congressional reaction may well bear fruit. H.R. 6778, Congressman Patman's bill, was passed by the House in amended form on November 5, 1969. 115 CONG. REC. H10574 (daily ed. Nov. 5, 1969). At this writing the bill is before the Senate Banking and Currency Committee. The Committee is scheduled to begin its hearings on H.R. 6778 and related measures on May 12, 1970.

assertions in its 1969 annual report, City Investing categorically and unequivocally rejected pooling accounting and, instead, opted for purchase accounting.²⁷

This gave rise to a hosanna — for here goeth the ultimate of integrity, an utter disdain for the cheap coin of the poolers, a rejection of the temptation of surfacing as gains that which was nought but suppressed appreciation existing at the time of the acquisition. So it came to pass that my faith in mankind suffered an especially agonizing blow when I read in a December, 1969, City Investing prospectus that they may have been proceeding with the voice of Jacob, but yet there was the hand of Esau. This most recent prospectus reveals:

City accounted for its acquisition of The Home Insurance Company on August 31, 1968 as a "purchase of assets" rather than as a "pooling of interests". As a result, City was required, in accordance with generally accepted accounting principles, to establish a new cost basis of Home's net assets at the date of acquisition based upon the fair values of Home's assets and liabilities in the light of conditions then prevailing. In arriving at such fair values . . . (ii) in determining the estimated realizable value of Home's investment portfolio as of the date of acquisition, it was considered appropriate, in the opinion of City's investment bankers, to recognize a discount from quoted market of \$65,709,000 in the case of equity securities and \$14,074,000 in the case of bonds and other evidences of indebtedness so as to reflect liquidation factors such as block transaction discounts, type of market, trading volume and similar factors As a result of the foregoing adjustment . . . (iii) the aggregate amount of gains ultimately recognized in City's income from the sale of all portfolio securities held by Home at the date of acquisition (when and if all such securities are sold) will exceed by \$79,783,000 the amount that would have been recognized if such adjustments had not been made.²⁸

Now this revelation raises within me the following urgent question: How were the City Investing auditors able to satisfy the standards presumed for purchase accounting and yet give to management a flying head start of about \$80 million for the acquired securities portfolio? City Investing was thus enabled to inject its 1969 statements (as well as subsequent statements) with gains which it assured us in its 1968 prospectus it was disavowing and which its 1969 report implied it had in fact rejected. This kind of earnings injection is precisely what we had a right to presume purchase accounting proscribed. As it turned out, that was our myth.

What may turn out to be an even more monstrous distortion may still be only in the gestation stage. City Investing has reported earnings for the nine months ended January 31, 1970, inclusive of gains on "real estate and investments" of \$25,437,000.²⁹ To the extent that this includes any of the Home Insurance realized gains for the period it would represent what I consider to be, in all fairness, something of a canard. This is so because Home's 1969 *Annual Report* shows \$70 million in *realized* capital gains but then sets forth an *un-*

27 *E.g.*, 1969 CITY INVESTING CO. ANN. REP. 33: "ACQUISITIONS DURING THE CURRENT YEAR ALL OF WHICH WERE ACCOUNTED FOR AS PURCHASES ARE AS FOLLOWS:

"(A) THE HOME INSURANCE COMPANY"

28 CITY INVESTING CORP., PROSPECTUS, Dec. 5, 1969, at 8.

29 CITY INVESTING CORP. THIRD QUARTER REPORT (1970).

realized investment loss of over \$154 million.³⁰ There was, then, an actual deterioration of a whopping \$84 million in the value of Home's security portfolio during this interim period.

If we remember that City Investing paid at least full value for Home's securities portfolio as an incident to its takeover, then it might fairly be said that City has sustained an economic loss during Home's reporting period (which does not quite coincide with the fiscal periods of City's reporting) of \$84 million. If, therefore, City proceeds to report a gain by reference to the Home portfolio while at the same time rationalizing such reported gain by reference to GAAP, it would be yet another cruel manifestation of the perverse potential in the practical application of our underlying body of accounting principles.

C. National General — Great American Insurance

The saga regarding the third of the conglomerate-insurance company tandems is still incomplete, since National General recently indicated a switch in its fiscal year reporting from September 30 to December 31. But yet there are anticipatory indications of income injection, using the insurance company portfolios as the catalyst.

In its fifty-two-week interim report (through last September 23) National General included as a part of its reported investment income "net realized gains of \$10,286,000."³¹ In view of the fact that this was the "Year of the Bear" this income amount is remarkable on two counts. First, in the January 10, 1969, prospectus renewing the exchange offer for Great American shares, National General assured us that: "For purposes of National financial statements, the Great American investments . . . initially will be valued at market, and net gains or losses realized by Great American which are attributable to increases or decreases in value prior to National's acquisition will not be included in National's reported income."³² Second, Great American has reported that it suffered an actual economic loss in its investment values of about \$31 million during the nine months ended September 30, 1969.³³

Now how National General was able to pick up \$10 million in gains when the insurance company statements reflect an actual major shrinkage for the period essentially coinciding with NG's control thereof is presently beyond my comprehension. The definitive 1969 statements expected to be promulgated over the next month or two might provide the answers. Is it possible that the assurances in their prospectuses notwithstanding NG has been given the kind of head start the auditors gave to City Investing? Alternatively, has National pursued an eclectic policy whereby it disposed of securities that showed appreciation subsequent to the acquisition, all the while permitting losses to lie fallow and to fester?³⁴

30 1969 HOME INSURANCE CO. ANN. REP. 3.

31 NAT'L GEN. CORP., INTERIM REPORT FOR THE FIFTY-TWO WEEKS ENDED SEPT. 23, 1969.

32 NAT'L GEN. CORP., PROSPECTUS, Jan. 10, 1969, at 19.

33 See [current volume] MOODY'S BANK & FINANCE MANUAL 1413.

34 Late March, 1970, brought forth the dismal news that National General Corporation was switching signals and its accounting field rules in the development of its definitive state-

One final note on this acquisition. After its takeover National General demonstrated that Leasco was a "Little Leaguer" when it took out but \$39 million from Reliance. National raised the ante with an actual withdrawal of \$174,540,824 as a dividend.³⁵

Again, at the very time when there is an urgent need for increases in our insurance underwriting potential we see illustrations of drains by but two conglomerates of more than \$200 million of liquid insurance reserves. Add to this the shrinkage in reserves resulting from the substantial reductions in "admitted asset values" triggered by the precipitous declines in stock market prices and we can see why insurance has become very much of a "seller's market."³⁶

D. Summary

Clearly, then, there are critical deficiencies in our process of accountability whereby corporate managements are capable of managing and massaging their earnings by huge injections of specious income bundles — amounts of reported income not achieved by the managements claiming credit therefor, or amounts which are merely half-truths in that they reveal gains which have been nominally realized while ignoring completely the stagnant pools of losses.

In any event, the objectives of the conglomerates to "rev up" their earnings

ments for calendar year 1969. Thus, despite the substantial income reported by its September 30 interim statements, National General showed a loss of almost \$96 million (before tax credits) for all of 1969. This means that for the last three months of 1969 the loss was a whopping \$107 million.

The operating revenues of National General (consolidated with those of Great American) did not fall apart during the period (although it now appears that even their ordinary operations showed a loss). Instead, National General determined not to perpetuate the surfacing of realized gains from securities while permitting losses to fester (the practice complained of in this article in chief); rather, it marked down the carrying value of the securities portfolio by nearly \$71 million. In addition, National General has swallowed the bitter pill by writing off further losses of almost \$24 million on its investment in Performance Systems, Inc. (née Minnie Pearl).

Lest the reader conceptualize National General's turnabout as a case of a fallen angel seeking salvation and determined to stay on the highroad henceforth, he is forewarned: The introductory letter "To Our Shareholders" found in National General's 1969 *Annual Report* makes it clear that the adjustment of the company's securities portfolio to December 31, 1969, market values is "a unique action which does not represent the adoption of a policy of adjusting the portfolio to reflect market fluctuations." 1969 NAT'L GEN. CORP. ANN. REP. 2. What this means is that after having absorbed its paper loss of about \$71 million on the portfolio write-down, National General's management may pursue its eclectic process of passing that much more into income while continuing to submerge its festering losses.

Sometimes it seems that corporate managements are much like the Bourbon Kings who are reputed to have learned nothing and forgotten nothing.

³⁵ See Schedule D, Part 4 of the Convention Report filed by Great American for the year 1969.

³⁶ For a detailed analysis of the attractiveness of large insurance companies for conglomerates and a demonstration of the seriousness and pervasiveness of this phenomenon, see Norgaard & Crary, *Identifying Merger Targets in the Property and Liability Insurance Industry*, FINANCIAL ANALYSTS J., Jan./Feb., 1970, at 91. In their conclusion Professors Norgaard and Crary state:

Several factors have made insurance companies particularly desirable for conglomerates. The most important of these is a ready supply of liquid assets.

Although there is no clear evidence as to the effect of the present acquisition movement, it seems reasonable to hypothesize that conglomerates will use the acquired insurance companies as a source of funds for other ventures while they make some attempts to correct management deficiencies. Whether they can succeed in the latter seems problematic. *Id.* at 94.

and collateral P/E ratios were very significantly accommodated by the flexibility of GAAP; and these objectives, as I have noted, were capable of being implemented essentially regardless of the way in which the pooling-purchase option was exercised.

Before sharing with you my views regarding an approach to a better process of corporate accountability, let us first briefly consider the collateral accounting problem posed by conglomerates, that of "divisional financial reporting."

V. Divisional Financial Reporting

The chronology pertaining to segmented reporting by diversified companies begins with Professor Joel Dirlam's testimony at congressional hearings held in 1965 to investigate factors affecting economic concentration.³⁷ Professor Dirlam suggested that information regarding "the relative profitability of different divisions and product lines" was essential for the purpose of continuing congressional inquiry as well as for effective decision making by investors. That this is true in the latter context is implicit in the fact that different industries enjoy different P/E ratios — to determine the consequences of a "mixture problem" it becomes necessary to know the respective ingredients of the mix, hence the need for such divisional reporting. And if a competitive society is rooted in a free flow of information regarding industry profits and profitability potential, then we must avoid the obfuscation of the undifferentiated mass, the bouillabaisse.

The multiplicity of objections raised to the proposals for segmented reporting are set forth in great detail (together with tables of frequency) by Professor Mautz³⁸ and are presented much more succinctly by Professors Rappaport and Lerner.³⁹

Probably the cleverest and most biting presentation of "the elusiveness of the concept of divisional net profits" took the form of a fable by Professor Howard C. Greer in his "Chop Suey Caper."⁴⁰ In that entertainment, Professor Greer points up the critical problems of accounting for joint or common costs, determining the fair and proper "profit centers," accounting for intracompany transfers — all leading up to his recommendation that the Accounting Principles Board "respectfully petition the SEC to forget the whole project [of segmented reporting] on the ground that anything they promulgate will inevitably do more harm than good."⁴¹ Clearly, Professor Greer saw things as they are and told "why not." In so doing, he was speaking from a depth of experience of his many years as a teacher, writer, business executive, and corporate director. He was undoubtedly especially aware of these complex problems with regard to the complex meat-packing industry, since he was the Executive Director of the American Meat Institute for a dozen years.

37 *Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary Pursuant to S. Res. 40*, 89th Cong., 1st Sess., pt. 2, at 769 (1965).

38 R. MAUTZ, *FINANCIAL REPORTING BY DIVERSIFIED COMPANIES* 21-30 (1968).

39 See A. RAPAPORT & E. LERNER, *A FRAMEWORK FOR FINANCIAL REPORTING BY DIVERSIFIED COMPANIES* 46-47 (1969) and authorities cited therein.

40 Greer, *The Chop Suey Caper*, *J. OF ACCOUNTANCY*, April, 1968, at 27.

41 *Id.* at 34.

With due deference to Professor Greer, I strongly suspect that if he really wanted to dream of things that never were, but should be, he most certainly could have developed a positive, effective solution to the accounting problems of diversified industries.

My unqualified confidence in the highly pragmatic view that "if he had the will he'd find the way" is rooted in the ways in which Wilson & Co.'s auditors found the way of segmenting its operations when Ling-Temco-Vought told them to. Remember, I'm here speaking about the "chop suey-est" industry of all, meat packing — the one in which Professor Greer possesses extraordinary expertise.

When, in 1967, LTV determined to deploy old Wilson into the three little Wilsons, it prepared separate and complete prospectuses for each of these three companies; each prospectus included statements of income for the respective entity showing what its separate sales, expenses, taxes, and net income would have been for each of the five years preceding the takeover and subsequent step-down. And to prove that these statements were all properly presented, each prospectus had its own "Opinion of Independent Auditors" addressed to the Board of Directors of the particular company. The certificate does not quibble — it says very explicitly that the pro forma income statements for each of the five years there presented were "in conformity with generally accepted accounting principles consistently applied."⁴² And lest there be any doubt as to how they decided upon this *nihil obstat*, they assured each of the respective boards that: "Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."⁴³

Professor Greer's article would have us believe such a retrospective pulling apart of long-since-digested chop suey is beyond the realm of feasibility; and even if it were not, he would urge that it "will inevitably do more harm than good." But when the company wills it otherwise, the independent auditors are entirely capable of obliging it — with assurances that the statements are all fair and good and all in conformity with the good doctrine.

And, as if to exacerbate Professor Greer's "Chop Suey Caper," when it turned out to be even more in accord with LTV's objectives to subdeploy the assets and operations of the new Wilson "meat ball" into four little sausages — the one to slaughter and sell livestock in the East and Midwest, another in the Midwest and West, a third to slaughter and sell lambs and cattle, and the fourth poultry — the same auditors were capable of preparing pro forma statements of income for each of the new four subsidiary entities, again reaching back into the dead coals of five years past. And the auditors (judging from their certificate given last December) were entirely capable of asserting that: "In our opinion, the pro forma net income [of the four new companies] have been properly

⁴² *E.g.*, WILSON PHARMACEUTICAL & CHEMICAL CORP., PROSPECTUS, August 15, 1967, at 20.

⁴³ *Id.*

compiled to reflect the assumptions described in the notes to the respective pro forma statements and summaries of the [new entities]."⁴⁴

All one needs to do is to review what the Wilson, sub-Wilson, and sub-sub-Wilson auditors were capable of doing in this single, most complex, situation and we have an immediate and effective response to almost all of the arguments heretofore advanced in objection to the demands from investors, government, the business community, and labor, for segmented reporting by diversified industries.

Now nothing in these remarks should lead to an inference that I consider the problem of effective divisional reporting to be one of simple expedition. To the contrary, I consider the problem to be too serious to be left to management and their designated independent auditors alone. For me the problem is part and parcel of the nexus of problems involved in the determinations under section 482 of the Internal Revenue Code (which gives to the Commissioner the right to reallocate income and deductions among related taxpayers);⁴⁵ determinations under the Robinson Patman Act;⁴⁶ and the General Accounting Office's quest for a more effective system of accounting controls over firms negotiating federal contracts.⁴⁷ In fact, I see the solution to this particular problem as an integral part of the solution to the overall corporate accounting dilemma presently confronting us.

VI. *Quo Vadis?*

In my approach to the solution of the accounting dilemma as a whole, I am especially partial to the very first of the aphorisms collected by the late George O. May in his *Memoirs and Accounting Thought*:⁴⁸

The test of the corporate system and of the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These must be judged from the standpoint of society as a whole — not from that of any one group of interested parties.⁴⁹

Continuing with my debt to George May in my search for an ultimate solution, be it remembered that he had urged (almost two score years ago) that each listed corporation be required to formulate a statement of the methods of accounting employed by it and that the formulation be "in sufficient detail to be a guide to its accounting department, to have such statement adopted by its board so as to be binding on its accounting officers; and to furnish such state-

44 WILSON & CO., INC., PROSPECTUS, Dec. 22, 1969, at 80.

45 INT. REV. CODE OF 1954, § 482 provides that:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

46 15 U.S.C. §§ 13a-c, 21a (1964).

47 See GAO *Urges Uniform Accounting Practices for Firms Negotiating Federal Contracts*, The Wall Street Journal, Jan. 19, 1970, at 9, cols. 1-2.

48 G. MAY, MEMOIRS AND ACCOUNTING THOUGHT OF GEORGE O. MAY (P. Grady ed. 1962).

49 *Id.* at 293.

ment to the Exchange and make it available to any stockholder on request"⁵⁰

Now then, from the vantage point of the decade of the seventies there is an even more compelling need for just such a specific, detailed formulation to be filed with the SEC and the exchanges, to serve as a covenant between the corporation and all those responsible for its accountings and all the parties in interest. Such a formulation should now be made responsive to the broad spectrum of present-day demands for fairer corporate accountability. Such a formulation could set forth not only the field rules for corporate accountability in general but could extend to the body of assumptions required for the divisional or segmented reporting which is embroiled in the different controversies alluded to previously.

And because this formulation is not privy to corporate management, I urge that for every major public corporation (with sales, say, exceeding a quarter of a billion dollars) the book of rules be promulgated by a consortium composed of representatives from management and their counsel and independent auditors, of course, but composed also of non-management-designed directors (to represent the shareholders) as well as representatives from the Federal Trade Commission, General Accounting Office (if government contracts constitute a significant phase of the entity's business, as they undoubtedly would), and from the Internal Revenue Service. Such a consortium would develop the statement of methods of accounting to be employed by the particular corporation only after meaningful consultation with representatives from (for example) the Census Bureau (because of its responsibility for the standard industrial classifications), the Department of Defense (to obviate any national security impairment), the Financial Analysts Federation, and the Department of Labor and organized labor (since the resultant formulation would undoubtedly affect future wage negotiations). Such consultation would also extend to representatives from the consumer sector as well as from our "society generally," since the process of corporate accountability will, in the foreseeable future, undoubtedly embrace the totality of the corporation's relationships with its environment (i.e., to demonstrate whether the entity has a salutary or inimical effect upon the human and material resources of the communities where it functions).

The omission of the Securities and Exchange Commission from the foregoing roster was entirely deliberate. I would want it to be the independent agency of first impression — to receive from the consortium the book of rules adopted for the particular corporation and to determine whether there are any gaps or other inadequacies. The SEC might also act to mediate any differences among the members of the corporate consortium and might develop a "data bank" of accounting alternatives and the circumstances where they had been applied. I would hope that the Commission would then avoid *ex parte* deliberations with any particular segments of the consortium; instead, I would wish that all of its proceedings would be formal and "on the record."

Such an overtly formulated catechism of accounting assumptions for the entity would have the added virtue of objectivity. And here I am especially

partial to Professor Oppenheimer's "different notion of what we mean by objectivity," thus:

All over the world . . . we check each other's experiments. In that sense it is a most objective part of our knowledge, and a most well-verified one. These comparisons are possible because we can tell each other how we have gone about an experiment and what we saw and what we found. Mistakes are made, but they are found very quickly. The objectivity which we see . . . is a characteristic of the way we can talk with others about it, of the lack of ambiguity and of the reproducibility and the verifiability of our communication with each other.⁵¹

Such an overt formulation, in our context, should permit us to find our mistakes "very quickly." It should permit us to "talk with others" about our particular "experiment" and thereby permit a "lack of ambiguity and of the reproducibility" regarding our accounting processes. It should thereby contribute to the "verifiability of our communication with each other."

Granted, I would be infringing on the managerial prerogative as it is presently conceived; nevertheless, our corporate society is too much a part of the totality of our society to permit the accounting formulation envisioned by George May to be left essentially to a single sector of our total society.

I would then recommend the creation of an Accounting Court, possibly structured along the lines espoused by my distinguished colleague, Leonard Spacek.⁵² I would expect the judges on this court to be independent, of judicial temperament, thoroughly knowledgeable in the precepts and practices of accountancy, and dedicated to the transcendent aims and objectives of the entire process of corporate accountability.

As I envision it, such a court would be in a position to encourage the best in the formulation in the book of rules and then to our adherence thereto in practice. Further, such a tribunal could discern and move to strike down any conflicts of interest that can, and all too frequently do, arise in the conduct of the professional practice of accountancy. Further, a court so independently structured should be able to avoid the quagmire in which the Institute's Accounting Principles Board finds itself.

VII. Saving the Conglomerates from Themselves

Finally, I direct my attention to the question — assuming that it becomes a matter of national policy to encourage or induce the dissociation or uncoupling or dismemberment of conglomerates — what needs to be done, and by whom?

The question is most critical at this moment in the history of the conglomerate movement. Even a cursory study of the financial press will disclose that these entities are in serious straits. Their share values are marked down as much as eighty percent from where they were just a year ago; and these conglomerates regularly find themselves among the new "1970 Lows" tabulated by the

⁵¹ R. OPPENHEIMER, *THE FLYING TRAPEZE: THREE CRISES FOR PHYSICISTS* 53-54 (1964).

⁵² L. SPACEK, *The Need for an Accounting Court*, in *A SEARCH FOR FAIRNESS IN FINANCIAL REPORTING TO THE PUBLIC* 27 (1969); see also *id.* at 555-82.

Wall Street Journal. Their bonds, generally convertible, are selling at discounts ranging up to half of par value. And there's no end in sight to this disintegration. So serious is the crisis in confidence, so wide is the credibility gap, that — even when their managements assure the financial community that they will no longer pretend that the emperor is clothed in the most gossamer raiment, that they are now weaving a genuine homespun fabric — the community still refuses to believe in the integrity of the report. And of course any management-inspired predictions of a better tomorrow are forthwith rejected, or at least discounted as a mere public relations subterfuge.

It must be remembered that these conglomerates are hurting especially badly from the share and bond price disintegration for a number of interrelated reasons. They issued their bonds and other forms of "funny money" never expecting to have to pay the principal and were certain that the interest would have to be paid only for brief intervals. The bonds, they were confident, would be converted into common shares over time, and to the extent that they were not, management would force a conversion through calling them.

Never expecting to have to pay up on the debt, the conglomerators felt free to raid (consistent with the legal amenities) the acquired corporations, plundering their pools of liquid resources. We saw that most dramatically in the insurance company acquisitions; it happened on the Wilson acquisition. In fact, the raid on the corporate treasury was part of the conglomerate's *raison d'être* — idle liquidity as reserves for a dismal tomorrow was the fetish of the traditional management. The whole process of "leverage" demanded that the money be made to perform at its highest levels of immediate return. And if the acquired company had mortgageable properties, well then borrow against them in order to generate more of the "vigorish" required for further acquisitions.

And now they have run out of liquidity. To make matters worse, while the conglomerates were previously capable of attracting the best of the new breed of management by offering various forms of non-cash compensation (options, restricted stock plans, and the like), things have now changed drastically. They have to part with more of the "green stuff" in order to attract required managerial talent.

This tale of woe could be developed even more extensively and in greater depth. The conglomerators can be seen to be in the same unfortunate predicament as the dictators referred to by Sir Winston Churchill in 1937. They are riding, he said, "to and fro upon tigers which they dare not dismount. And the tigers are getting hungry."⁵³

And there are hungry tigers all about. Thus, there may well be some traditional corporations with very substantial assets ready to take over these free-form conglomerates. Also, there are undoubtedly in the making some yet tiny winds gathering speed, soon to move with hurricane force against the conglomerates which we presently have in mind. One never knows when some ambitious, aggressive management might concoct a new four letter acronym for some new aspect of technology or ecology or other branch of the occult, go public with nothing but a glorious promise, get the blessings of the Gnome

of Zurich in the form of an astronomical P/E ratio, and then proceed to swallow our ill-starred conglomerates.

Or what may be even more immediate and pervasive a contingency is the inability on the part of these entities to meet their debt responsibilities. We may see disgruntled creditors move into controlling positions, ousting the conglomerators. This might be deemed to be fair retribution, natural justice and equity, and the like. But here we must pause to realize that the bondholders or other major creditors are frequently persons or groups who may not have heretofore revealed their identities. Much of the recent financing has been with foreign banks, trusts, and funds. If the control of the conglomerates passes into the hands of these faceless creditor groups are we prepared to say that this is consistent with the transcendent objectives of our American economic society, of our shareholders, labor, consumers, taxpayers? For recent manifestations of the contingency about which I am here expressing my concern, I respectfully direct the reader's attention to the fact that within the very recent past, in two essentially unrelated instances, in the Perfect Film and Commonwealth United fiascos, the managerial prerogatives shifted to Investors Overseas Services Ltd. All one need do is to read the recent proxy statements of Commonwealth to see the ways in which banks, et al., in Luxembourg, the Bahamas, France, England, as well as the Fund of Funds, insinuated themselves into the action.⁵⁴

It may be, as I have noted, a matter of natural justice and ironic retribution, but should the totality of our economic and political society be compelled to accept the consequences of this overreaching on the part of the conglomerators who took to "riding the tiger"? It is my view that the consequences that may flow from the further disintegration of our conglomerates are too severe to permit them to follow inexorably.

So to take the lead from the suggestion frequently advanced for a resolution of the other "Cong" dilemma, I recommend the "enclave" approach to a solution of our impending conglomerate crisis. Thus, the consortium to which I alluded previously, together with representatives from the Justice Department, might well be called upon to formulate plans for the stepping-down of viable segments of the conglomerate's properties (subject to appropriate liabilities), and to make immediate provision for independent managements of the several components. Then, after an appropriate period of gestation, the shares in these several "enclaves" could be distributed to the shareholders of the parent corporation.

Our tax laws (especially subchapter C) would undoubtedly permit this restructuring to be accomplished tax-free, even without any major amendment. To the extent legislative change might be required (possibly because the conglomerates have not yet owned the constituent properties for an adequate period of time), they could probably be effected with expedition.

Undoubtedly a study of the way in which divestiture was effected under the Public Utility Holding Company Act⁵⁵ and, more recently, the manner in which the divorcement of motion picture theatres from producing companies

54 *E.g.*, COMMONWEALTH UNITED CORP. PROXY STATEMENT, Dec. 29, 1969.
55 15 U.S.C. §§ 79-79z-6 (1964).

was achieved, could be most informative in policy determination and implementation in this regard.

VIII. Conclusion

This essay's principal purpose was to consider the ways that the flabbiness of current accounting practices and procedures contributed importantly to the merger movement during the sixties. While it can be expected that the specific practices here complained of will eventually be either formally eliminated or their effectiveness severely attenuated,⁵⁶ whether or not this expectation is fulfilled, the basic question will still remain: Should the accounting profession have knowingly lent itself to the process of income distortion by permitting the income injection phenomena we have examined, knowing full well that since "the medium is the message" these injections would have an exhilarating (though momentary) impact on the share prices of the companies using these ebullient methods?

As we have observed, our system of publicly owned corporations requires the delegation of huge bundles of power to professional management. We may ponder whether the auditors who sanctioned the practices that we have discussed have truly demanded a full and fair accountability from those to whom power is delegated — professional management — in favor of all persons in this economic republic who have a right to know how that power has been utilized.

In my view, this point was made especially felicitously by Mr. Justice Douglas:

The functioning of our capitalistic society is rooted in confidence in those to whom power is delegated. That requires a functioning system of checks and balances; and that in turn demands the effectiveness of communication between and among the various elements in the society and system. In that communication the accountant should play a crucial role.⁵⁷

⁵⁶ The Accounting Principles Board has promulgated, as of February 23, 1970, an *Exposure Draft* for a proposed *Opinion* on "Business Combinations and Intangible Assets." The *Exposure Draft* is presently the subject of major controversy and there is no assurance as to just what form the ultimate *Opinion* will take.

⁵⁷ Douglas, *Foreword* to A. BRILOFF, *THE EFFECTIVENESS OF ACCOUNTING COMMUNICATION* at VIII (1967).