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What People Are Writing About

Authors
Park Leathers; Harold I. Purcell; Paul Allan Pacter; Ahmed A, Shinawi; Eugene J. Corman; and Shirley M. Arbesfeld

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what people are writing about

BOOKS

Management Services by Accounting Firms by William E. Arnstein, CPA, with the assistance of Herman Burstein, The Ronald Press Company, New York, 1967, 444 pages, $12.

This review of the management consulting services that are available from public accounting firms seems to be basically promotional in intent, but it also offers the business reader a useful (though highly condensed) summary of some of the best of modern management techniques for cost reduction and profit improvement.

As every reader of this magazine knows, business' use of CPA firms for help in areas outside auditing and tax work has grown tremendously in recent years. Few businessmen have a comprehensive picture of the scope of the services and how they are rendered. This book seeks to provide such a perspective for executives, bankers, attorneys, lenders, and investors.

The principal author of this book, partner in the management services department of S. D. Leidesdorf & Co., is a former chairman of the committee on management services of the New York State Society of CPAs, a former member of the committee on management services of the American Institute of CPAs, and a former consulting editor of Management Services. He and Dr. Burstein, economist and statistician for S. D. Leidesdorf & Co., have contributed articles to this magazine.

After a brief description of the nature of the management services practice of accounting firms the book discusses the specific techniques that are frequently introduced into a business by the consultants. Primarily these are techniques for control of operations and for office management and ac-

REVIEW EDITORS

In order to assure comprehensive coverage of magazine articles dealing with management subjects, Management Services has arranged with fifteen universities offering the Ph.D. degree in accounting to have leading magazines in the field reviewed on a continuing basis by Ph.D. candidates under the guidance of the educators listed, who serve as the review board for this department of Management Services. Unsigned reviews have been written by members of the magazine's staff.

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counting methods, systems, and procedures.

Obviously the scope of the book is broad. Subjects, all areas in which at least some CPAs offer consulting service, include management reporting, budgeting and profit planning, financial controls, corporate planning, inventory management, personnel administration, mathematical techniques, sales forecasting, marketing expense control, marketing policy, cost accounting and reporting, cost control, production planning and scheduling, plant facilities and materials handling, data processing methods, systems design, clerical cost reduction, filing and records management, and paperwork flow.

Obviously, too, the discussion of each subject is brief. Such topics as PERT and job evaluation get a couple of pages. As the authors explain, the techniques are described "in sufficient detail that the businessman will be able to understand their basic methods and purposes . . . to determine whether the profits of his business could be improved by introducing one or more of these management tools."

Thus the book is, as the publisher puts it, a sort of "catalog" of management techniques. It is also in practical effect a catalog of the management services offered by CPA firms, from which the businessman can pick the services he needs and from which the CPA can pick the services he might like to offer.

How to Look for a Job by William B. Owen, Modern Publishing Company (Box 186, 10 Pearl Street, Norwalk, Connecticut), 1967, 16 pages, $1.

Despite its somewhat misleading title, this useful booklet is aimed at the experienced executive, not the graduating senior.

Written by an executive recruiter who really knows the ins and outs of the executive job market, this little manual should be invaluable to the manager who is between jobs or restless in his present one.

The author assumes that men at the executive level know what to do once they have been invited for an interview. Therefore his purpose is not to teach qualified executives how to get a job but rather how to look for one—"to help answer the most difficult question of them all: 'Where do I start?' "

Mr. Owen lists and discusses the principal paths the executive job-seeker can follow: personal contacts, personnel agencies, executive recruiters, executive job counselors, answering newspaper ads, writing letters to companies, and cold calls on companies and executive recruiters. He rates each method in terms of the degree of privacy it provides, the time it takes, and the compensation level for which it is suitable.

Little space is devoted to the resumé—since there are so many books on this subject—although a couple of examples are included. Mr. Owen devotes more attention to the selling letter, with examples and critiques of them. He also tabulates the relative suitability of the resumé, selling letter, and biography for the various job-hunting methods. He concludes with a list of standard reference works that are helpful in the search.

Mr. Owen knows a good deal about this field, and his pamphlet, brief though it is, is probably one of the most practical job-seeking guides available to the executive.

The Technical Program Manager's Guide to Survival by Melvin Silverman, John Wiley & Sons, Inc., New York, 1967, 124 pages, $6.95.

This little how-to-do-it book offers a quick but probably practical guide to project management.

The transition from technical specialist to managerial generalist is always difficult—and particularly so in the case of program management, for the program is as new to the company as the manager is to the program. The author of this book, formerly manager of program management for the controls department of the Kearfott Division of General Precision, Inc., has been through it all many times, and he has tried to set down a generalized guide to the fundamentals.

After a brief discussion of the general concepts of program management and management in general, the book follows through on a generalized design-production-supply sequence. It outlines the essentials of organization, contract negotiations, financial management, systems engineering, quality control, procurement, contract management, production, and phase-out, briefly explaining such management tools as Gantt charting, PERT, and Line-of-Balance. And it offers tips for getting along with superiors, subordinates, and other departments.

The style is clear and direct although cliché-ridden. Over all, the book has an air of authenticity. It is clearly based on experience, and, for its somewhat specialized market, it has obvious practical value.

The Hertz Survival Manual for Traveling Businessmen edited by Garth Hite, Norman Reader, and Burton Richard Wolf, Renaissance Editions, Inc., New York, 1967, 667 pages, $7.95 (hard cover), $2.95 (paper back).

This guidebook to 28 major U.S. cities omits much of the standard tourist information and substitutes listings of services the traveling businessman is likely to require.

Where in a strange city to rent a tuxedo, get glasses repaired, get documents copied, and, of course, rent a Hertz car are among the tidbits of information offered in this fat manual for the business traveler.

For each of the major cities cov-

ered, ranging alphabetically from Atlanta to Washington, D.C., the guidebook provides background information; tips on business entertaining, office hours and holidays, local weather and tipping, and getting around (with city maps and routes to airports); and listings of sources of business and emergency information.

Sightseeing and other tourist information is dropped, except for rather sketchy listings of hotels, motels, and restaurants. Instead, there are directories of some fifty services the traveling businessman might need, including barbers, catering services, secretarial services, interpreters, locksmiths, messengers, out-of-town newspapers, suppliers of visual aids, and even pawnbrokers. Introductory chapters provide suggestions on travel planning (including credit cards, luggage, and dictating equipment) and on taxes and expense accounts.

Car rental is spoken of approvingly, and no Hertz competitors are listed. Otherwise, the book, based on information supplied by travel editors of local newspapers, seems to be factual and unbiased.

Unquestionably it fills a real need. The guide, which will be revised annually, will be sold through normal retail channels and also will be available for inspection at Hertz offices.

MAGAZINES

Selecting a Route for Fleet Financing by Donald H. Shuckett and Edward J. Mock, *Financial Executive,* May, 1967.

The authors present exhibits showing how to choose, on a discounted cash flow basis, among various methods of financing a fleet of automobiles and give breakeven formulas for determining the point at which mileage allowances become too costly.

Five alternatives were considered: (1) purchase with funds on hand, (2) purchase with borrowed funds, (3) maintenance lease (lessor provides maintenance and covers similar costs), (4) finance lease (lessee provides maintenance), and (5) reimbursement of mileage.

Actual historical fleet costs and average mileages were used, discounted at an assumed cost of capital of 10 per cent.

Using the assumption that the company could only finance at its present cost of capital (and that the method of financing would not affect other investment opportunities), the authors found little choice between the two purchase methods. For the average auto mileage of 22,735 miles per year, the finance lease was least costly. The maintenance lease was slightly more expensive than purchase, and reimbursement of mileage, at ten cents per mile, was by far the most costly. The breakeven mileage point was 11,640 miles per year for use of the finance lease instead of reimbursement; it was, of course, higher for the other methods.

The data used should be varied for the individual situation. In addition, it might be appropriate to base federal income taxes on accelerated depreciation rather than on the straight line method. The value of the article is in presenting a framework within which the proper decisions can be made.

Park Leathers, CPA
University of Pennsylvania

Do We Need Generally Accepted Standards for Management Services? by Maurice B. T. Davies, *The California CPA Quarterly,* March, 1967.

The question is rhetorical. The author asserts the need for accepted standards in management services and proposes a tentative set of standards.

Mr. Davies proposes that standards for management services be developed by using as a framework and as a point of departure the auditing standards prescribed by the AICPA. These fall into three categories: (1) general standards, (2) standards of field work, and (3) standards of reporting.

He revises General Standard 1 (relating to the adequate training and proficiency of an auditor) to meet management services requirements as follows: "The assignment is to be performed by a person or persons having adequate technical training and proficiency in the specialized skills involved."

General Standard 2 prescribes an independence of mental attitude for the auditor. The author concedes that in giving management advice, especially to small clients, the CPA may become an independent adviser and in effect become part of management itself. This of course would weaken his independence as an auditor. Mr. Davies would modify General Standard 2 to apply to management services as follows:

"In all matters relating to an assignment involving advisory service an independence in mental attitude is to be maintained. However, in an assignment where the CPA exercises a function of management, as distinct from management counsel, the need for independence should be subordinated to protection of the client's best interests, in which case the CPA disqualifies himself from exercising the level of independence in mental attitude necessary for conducting an independent audit."

One might wish that the author had included in his standard more specific criteria for resolving the dilemma of independence. At what point does the performance of management services by the CPA compromise his independence as an auditor? Is it ever ethical to withdraw from the management services engagement in order to retain the audit? More important, how does the CPA avoid the temptation to have his audit and his management services engagement too?

The author accepts General Standard 3 unchanged except for

reference to oral reports sometimes required by management services engagements: "Due professional care is to be exercised in the performance of the assignment and the preparation of related reports, both oral and written."

Field Work Standard 1 states: "The work is to be adequately planned and assistants, if any, are to be properly supervised." The author adopts this standard without change.

Field Work Standard 2, relating to evaluation of internal control as a basis for determining the extent of audit tests, is not closely relevant to most management services assignments; however, a related standard is necessary in that a broad consideration of the implications of an assignment should be made even if the scope of the engagement is limited. This standard is expressed as follows:

"The scope of an assignment should be broad enough to encompass all matters likely to be of significance in producing the desired results, except where otherwise agreed with the client, who should understand the possible consequences of such limitations."

Field Work Standard 3 concerns the obtaining of evidential matter to afford a basis for an opinion on financial statements. Management services conclusions must also be based upon adequate examination of relevant facts, but the variety of assignments may permit a greater range in the degree of written evidence required by the circumstances. The author's suggested standard reads as follows:

"Facts relevant to the formulation of a conclusion are to be determined and substantiated by such means as are appropriate in the circumstances, such as inspection, observation, inquiries, or other means, and the implications of these facts are to be studied in reaching the resulting conclusions."

Auditing standards of reporting are not parallel to the problems of management services, but Mr. Davies suggests three additional standards that are related to the problems inherent in management services work. These problems include the risk of not being able to develop a solution to the clients' problems that will be satisfactory in view of such limiting factors as time, cost, degree of acceptance and implementation by the client of the recommendations, and the scope of the assignment. These last three proposed standards are grouped as follows:

"An assignment should be undertaken only if the CPA is reasonably satisfied, through initial investigation, that: the client will be willing to accept his recommendations; the client already has, or can make available, a staff capable of implementing the recommendations; and the cost to the client will be reasonable in relation to the expected benefits from the assignment.

"An assignment should be undertaken only after mutual agreement between the client and the CPA on matters relating to the purpose, scope, content, duration, and expected cost of the work, and in any assignment of substance this agreement should be reduced to writing.

"Each assignment is to be supported by a body of records and working papers to substantiate the work done, the facts derived, and the conclusions reached."

The author concludes his article by recommending that tentative standards be set by professional associations to provide guidelines for preliminary testing. After these standards have met the test of practical application and general acceptance, they should be promulgated formally.

The American Institute of Certified Public Accountants has encouraged the accounting profession to push forward into the area of management advisory services, and accounting firms have responded with enthusiasm, even to the extent of offering services well beyond the usual activities of accountants. Thus the need for an official statement of standards is urgent. Mr. Davies' article provides a useful vehicle for discussion and consideration by accountants concerned with the lack of generally accepted professional standards in this rapidly expanding field of activity.

Harold I. Purcell, CPA
University of Southern California

How to Audit Electronically Produced Records by Robert J. Monteverde, *Management Controls,* January, 1967.

This article explores changes in audit procedures and techniques necessary for the examination of electronically produced records.

The author, a manager with Peat, Marwick, Livingston & Co., considers the effects of electronic data processing on the audit procedures employed by independent and internal auditors.

"Because there are no changes in audit concepts or philosophy when dealing with electronically produced records, the general audit approach will remain unchanged," he says. This general audit approach includes the determination of the objective of each type of transaction, determination of the specific accounting principles that have been adopted, preparation of permanent files on the company's systems, evaluation of internal controls, and development of an audit program.

Although the general audit approach and objectives remain unchanged, specific procedures and techniques must be revised when auditing electronically processed records. Mr. Monteverde discusses several problems unique to the auditing of such records, including these:

1. Controls built into the computer's circuitry
2. Controls programed into the machine's operating instructions
3. Lack of hard copy postings and reports between the source documents and the summary statements
4. The advantages and disadvantages of auditing "around the machines" and instances when the

auditor can place reliance on this type of procedure

5. The advantages and disadvantages of auditing "through the machines" and instances when this procedure is superior or mandatory.

The uses, advantages, and disadvantages of both theoretical and live-data test decks are discussed, along with other techniques by which the auditor can utilize the electronic equipment to his advantage. Finally, 44 questions illustrate the types of inquiries the auditor should make when evaluating internal control.

Paul Allan Pacter
Michigan State University

Management Services: A Challenge to Audit Independence? by Arthur A. Schulte, Jr., *Accounting Review,* October, 1966.

The AICPA Committee on Professional Ethics has taken the position that the CPA can render management services without impairing his audit independence as long as "he does not make management decisions or take positions which might impair that objectivity." But are these the only two identifiable sources of a threat to audit independence?

Management consulting is a fast-growing area of the CPA's practice, and with it come many problems. A particularly important problem is whether audit independence is impaired by rendering management services. From Opinion No. 12 of the AICPA's Committee on Professional Ethics the author draws the following conclusions:

Contention One—The performance of management services impairs audit independence in two cases "where in acting as a management consultant the CPA may (a) make management decisions or (b) become in effect an employee."

Contention Two — Management services do not impair the appearance of independence of the CPA who is acting as a management consultant, "that is, it does not suggest to a reasonable observer a conflict of interest."

Independence

The author then goes on to evaluate these conclusions. He starts with two aspects of audit independence. "First, the CPA must possess a state of mind which makes him self reliant and not subordinate to his client and, second, the CPA must be free of any self-interest which might warp his judgment, even unconsciously, in expressing his opinion on financial statements." The second requirement, unique to the CPA's profession, is there because of the reliance of third parties on the CPA's report upon the fairness of the financial statements.

Dr. Schulte then analyzes the consultant-client relationship. In his capacity as an advisory staff man, the consultant participates in all the steps necessary for making management decisions—identifying the problem, finding and evaluating alternatives for solution, and presenting recommendations — but not in making decisions. In order to be considered truly professional, the consultant's advice and services must be integral to the whole decision process. Besides being an advocate for his client, the consultant in most situations is empathetic with the management decision maker. Once he is engaged to render advice and service the consultant's reputation is at stake. He also assumes direct responsibilities to his client and indirect responsibilities to third parties.

Potential conflict

Having stressed the meaning of audit independence and described the consultant-client relationship, the writer then relates these two areas. He discusses separately the following areas of potential conflict between the CPA's role as an independent auditor and his role as a business consultant:

Making decisions—By accepting the role of making management decisions, the CPA impairs his audit independence.

Becoming an employee—The consultant becomes an employee of the firm if he is engaged to fill a "gap" in management or to develop an internal staff. Hence he impairs his audit independence.

These areas of potential conflict have been identified by the Committee on Professional Ethics of the AICPA. However, Dr. Schulte finds additional areas that offer a potential challenge to audit independence:

Closeness to the client—By participating in the decision making process, the consultant often develops a close relationship with management. This closeness may impair his objectivity.

Advocacy position—In assisting in the solution of a problem the consultant may attempt to persuade his client, because any idea is worthless without implementation. On the acceptance of the consultant's ideas and recommendations depends his success. Thus, "the CPA becomes both logically and emotionally involved in the decision and its outcome." When he becomes so interested in and partial toward the results of recommendations which he will later audit, he is no longer objective. The consultant also impairs his audit independence when his client's interest becomes of "primary importance."

Self-interest—The quality of his work as a consultant is judged by results. As his prestige depends on results of his service, then he has a "direct financial interest" in the outcome of his consulting.

To assess whether the CPA's appearance of independence is impaired by engaging in management services, the writer used a mail survey of "four important groups of third parties who rely on certified public accountants' audit reports in making investment and credit decisions." These groups were financial analysts of brokerage firms, bank officers, investment officers of

insurance companies, and investment officers of domestic mutual funds. He assumed that these four groups represented "reasonable observers."

Sixty-seven per cent of the respondents did not believe that management services have serious influence on audit independence. They expressed two reasons for this belief: (1) The management consultant is not a decision maker. (2) They trusted the CPA's integrity to avoid conflict of interest with his audit independence.

Thirty-three per cent of the respondents doubted that a CPA could maintain his audit independence while he was rendering management services to the same client. They generally indicated that "their confidence in the CPA's audit independence has been lessened, to some extent" by the CPA's engagement in management services. Three reasons were given for their doubt: (1) a closeness to the client, (2) an advocacy position, and (3) a stake in the results of the consulting engagement.

Several respondents, especially from the larger companies, expressed an opinion that management services have less impact on audit independence in large CPA firms where management consulting and auditing services are performed by separate staffs.

Ahmed A. Shinawi
University of Southern California

Behavioral Assumptions of Management Accounting by Edwin H. Caplan, *The Accounting Review*, July, 1966.

This article develops two sets of assumptions regarding the relationship between the management accounting system and the attitude of the accountants and managers of the system toward human behavior in organizations.

It is Professor Caplan's contention that the accountants who design and operate management accounting systems are influenced in the selection of the measurable variables by their views of human behavior in organizations. He further suggests that the management accounting system reflects the theory of organization held by the management of the enterprise wherein the system is employed. The management accounting process is seen by the author as an attempt to influence behavior.

The article develops two sets of assumptions that underlie organizations in our society. For purposes of illustration, the author postulates behavioral assumptions on what he terms the "traditional" management accounting model of the firm and "modern" organization theory. The behavioral assumptions developed by Professor Caplan are summarized in two tables contained in the article, which provide an excellent outline and digest of the author's principal points.

'Traditional' model

The "traditional" management accounting model results from a blending of the economic theory of the firm and its assumed goal of maximization with the classical theories of organization attributed to early writers on the subject such as Henri Fayol, Frederick W. Taylor, and James D. Mooney. In the traditional model, the principal function of the management accounting system is to act as a control device to isolate variances subject to the "management by exception" principle. This model implies a somewhat mechanistic view of the human element in organization in that the individual is seen as a commodity in the production process. The management theory described by the traditional model is similar to that of McGregor's "Theory X" in *The Human Side of Enterprise* cited by Professor Caplan. The author feels that the traditional model predominates in today's business enterprises and that ". . . with respect to both its philosophy and techniques, much of contemporary management accounting is a product of, and is geared to, these classical theories."

Modern organization theory, as described by Professor Caplan, combines the decision-centered theories of the Barnard-Simon-March-Cyert models he cites with McGregor's "Theory Y" and the managerial philosophies of Chris Argyris (*Personality and Organization*) and Rensis Likert (*New Patterns of Management*).

'Modern' theory

In essence, the management accounting system in the "modern" theories is an information system to provide data for decisions as well as a part of the communications network within the organization. The "modern" theories reject the profit maximization assumption of the traditional model and substitute "satisficing" (satisfactory profits in terms of a dominant coalition's multiple objectives) and organizational survival as the major determinants of managerial decisions.

Although Professor Caplan warns against considering the traditional assumptions completely invalid, he gives the impression that he views the traditional management accounting system, spawned in the era of *laissez faire* capitalism, as also doomed to the "dustheap of history." As he states in the article, "The adoption of a more realistic model of behavior by accountants could place them in the position of leading rather than passively following the changes in management philosophy which are bound to occur as a result of the impact of modern organization theory."

In addition to the two behavioral models of the firm discussed in relation to the management accounting system, Professor Caplan might well have included a third major area of organization analysis, namely, the power-conflict models of theorists such as Neil W. Chamberlain and Kenneth E. Boulding. One of the major criticisms leveled against the models

presented by Professor Caplan is their failure to deal effectively with the question of conflict in organization.

The author observes that some management accountants see their function as that of enterprise critic or, worse yet, "... view the success of the accounting department and the technical perfection of the accounting process as ends in themselves." These, however, are not the "conflict" situations that require analysis. Those areas are usually considered "frictions" in that they lack the "clash of values" of real conflict.

Organizational realities

But, when the author asks the question, "... should the accountant be concerned with providing the kinds of information that management actually wants or the kinds of information that management should want?" he sets the stage for a classic example of organization conflict. Here he strikes at the basic structure of a business organization and forces the issue of value judgments to the forefront. If the management accountant of "modern" organization theory controls the information system to the extent that Professor Caplan implies he will, he is, *de facto,* the chief executive, and the managerial hierarchy of the typical organization chart is a set of empty boxes. The answer to Professor Caplan's question requires a third set of behavioral assumptions grounded in the realities of organizational life rather than the normative theories of the models illustrated.

Professor Caplan has performed a noteworthy service for those concerned with the management accounting process by pointing out the behavioral aspects of accounting and the related assumptions underlying the art. It is easy to overlook the fact that the management information system, of which accounting is a part, does have as one of its prime purposes the influencing of the actions of organization participants. If, as the author suggests, "The management accounting function is essentially a behavioral function ...," then, it is incumbent upon the accountant to recognize the basic assumptions that make up the control philosophy and framework and to select variables consistent with them. By postulating several possible sets of behavioral assumptions, Professor Caplan provides a base for further analysis.

Impact of technology

The author's suggestion that empirical research be conducted on the behavioral assumptions actually held by accountants and the consequences of these assumptions should furnish grist for graduate students seeking thesis and dissertation topics. This may not be the real issue, however. Our present technology and the direction in which it is headed speak volumes about the attitudes of modern science toward human inefficiency and wastefulness. And industry's concern with the products of science (computers, automatic factories, etc.) bespeaks its basic philosophy. A technology that seems bent upon supplanting individuals with machines would appear to exert more influence on the management accounting system than do the accountants' assumptions about human behavior. Nevertheless, empirical research in this area might demonstrate the incongruity between many current theories of what organizational behavior should be like and the direction our technology is actually taking it.

For those readers in Professor Caplan's audience who have not had the opportunity to keep abreast of the recent literature in the management area, this article contains many fringe benefits. It is an excellent summary of the decision-centered theories and provides more than sufficient bibliographical data for those who would care to pursue the subject further. Furthermore, the author's artful weaving of the economic theory of the firm with the principles of scientific management in order to extract the underlying assumptions of the traditional model certainly deserves commendation.

The reader sophisticated in the literature of management will find the tables developed by the author a handy and concise guide to the substance of the article and a great aid in grasping the logic of his argument.

This article is certainly to be recommended to the serious student (or practitioner) of management accounting. And, it might be noted, a remarkable feature of Professor Caplan's article is the fact that he wrote fourteen pages without once having to resort to algebra—certainly a rarity these days.

EUGENE J. CORMAN, CPA
University of Southern California

P/E Analysis in Acquisition Strategy by DONALD J. SMALTER and RODERIC C. LANCEY, *Harvard Business Review,* November-December, 1966.

This article reports the findings of a study of how price/earnings ratios are determined and draws some conclusions for use in corporate acquisition planning.

Acquisition of other companies has become an increasingly important element of growth strategy. The crucial test for the corporate candidate to pass before it is acquired is this: Will it maintain and possibly improve the acquiring company's price/earnings ratio.

The authors have conducted an extensive study to determine the factors affecting the P/E ratio. It appears to be based on psychological reactions to future prospects and on subjective judgments rather than on detailed, soundly conceived, quantitative analyses. They were able to select six factors controlling P/E ratios. Listed in order of importance, they are as follows: future per share earnings growth; minimum fluctuations in the earn-

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ings trend; earnings for the long run; heavy emphasis on research and development programs; frequent introduction of new products justifying the investors' confidence in large R&D expenditures; and activity in growth markets as a result of R&D programs and new products. The more speculative investors seeking capital gains tend to relegate to a lower status a high rate of return on investment, a high rate of earnings retention, and high rates of dividend payout and dividend yield. They also deemphasize a low level of debt utilization; many companies with high P/E ratios possess long-term debt in excess of 30 per cent of their capital structures.

Example

In the acquisition of a company by common stock or other securities exchangeable for common stock it is essential that the acquired earnings be evaluated for their per share contribution to the acquiring company. Will the acquisition upgrade earnings per share in the merged organization and improve its P/E ratio? Assume the following hypothetical situation: Company A is considering the purchase of either Company B or Company C. Both are believed to offer attractive opportunities and to serve Company A's needs and growth objectives. The pertinent financial data are as follows:

	Co. A	Co. B	Co. C
Sales (millions)	$300	$100	$100
Earnings (millions)	$ 25	$ 10	$ 10
Shares (millions)	10	2	2
Earnings per share	$ 2.50	$ 5	$ 5
Stock price	$ 45	$100	$ 75
P/E	18	20	15

Both B and C have the same assumed sales, earnings, and shares outstanding, but investor psychology has bestowed upon B a higher P/E ratio. This advantage which B has substantially differentiates the bargaining positions of B and C in merger negotiations.

The price negotiated for sale of B to A is $225 million or 22½ times estimated earnings, or 12½ per cent premium over its current P/E ratio. A will have to issue 5 million shares of its common stock ($225 million divided by $45). Earnings per share for the combined operations would be A's earnings of $25 million plus B's earnings of $10 million, or $35 million, divided by 10 million shares of A's outstanding stock plus 5 million shares issued to B, or 15 million shares, equaling $2.33 per share. The effect on A's shareholders would be a decrease of 17¢ per share ($2.50 minus $2.33), or a 6.8 per cent dilution.

The negotiated price of C is $150 million or 15 times estimated earnings. This is the same ratio as the current one on the market for C's stock. To make the purchase, A must issue 3.333 million shares of its common stock ($150 million divided by $45). Earnings per share for the combined operations would be A's earnings of $25 million plus C's earnings of $10 million, or $35 million, divided by 10 million of A's shares plus 3.333 million shares issued to C, or a total of 13.333 million shares, equaling $2.62 per share. The effect on A's shareholders would be an increase of 12¢ per share ($2.62 minus $2.50) or a 4.8 per cent gain.

Other considerations

The authors hasten to add that these numerical comparisons do not provide the answer. A must carefully identify its needs. A may have inadequacies in its R&D skills, manufacturing technologies, or patent position in an attractive growth market. By identifying its needs, A could establish some specific acquisition decision rules. For example, up to 5 per cent immediate dilution is acceptable even though acquired earnings may not grow as fast as A's projected rate, or the acquired company's P/E ratio should exceed 22.5. B does not strictly satisfy these guidelines. Perhaps B is attractive because it could save A several years in building a position in a desirable growth market. If not, how fast must B's earnings grow to eliminate immediate dilution? Assume A is planning on a 10 per cent annual growth rate in its per share earnings for current operations. B will have to grow at 18 per cent per year to eliminate dilution within three years and at the rate of 16 per cent to eliminate dilution in four years. Since these levels of earnings growth are very high, A's management is challenged to define the reasons that would justify some permanent dilution in its per share earnings.

This article is especially significant to accountants since earnings per share appear to be the critical factor in corporate acquisition policy. Unfortunately, the price/earnings ratio is not the result of the application of "scientific" methods. It is the result of an individualized mix of generally accepted accounting principles adopted by a company during a period of time. Perhaps it is incumbent upon the accounting profession to offer to the investing community other and perhaps better yardsticks for evaluating future profitability.

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