[Management Services: A Magazine of Planning, Systems, and Controls](https://egrove.olemiss.edu/mgmtservices)

Volume 7 | Number 3 Article 7

5-1970

Conglomerates' Goals -- And Their Attainments

Mohamed Onsi

Follow this and additional works at: https://egrove.olemiss.edu/mgmtservices

Part of the Accounting Commons

Recommended Citation

Onsi, Mohamed (1970) "Conglomerates' Goals -- And Their Attainments," *Management Services: A Magazine of Planning, Systems, and Controls*: Vol. 7: No. 3, Article 7.
Available at: https://egrove.olemiss.edu/mgmtservices/vol7/iss3/7

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Management Services: A Magazine of Planning, Systems, and Controls by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Many conglomerate companies on the glittering surface look like paragons of efficiency and economic wisdom. This author suggests, however, that perhaps the wrong indicators are being used to give this appearance of health and offers a more rigid measure of performance—

CONGLOMERATES' GOALS—AND THEIR ATTAINMENTS

by Mohamed Onsi
Syracuse University

In the early sixties, a business movement toward conglomeration emerged. The conglomerate company is believed to be different in its philosophy and organizational structure. The success of the leading conglomerate companies has impressed the financial and business communities, at least for a decade, with the conglomerate concept. The indicators of the success of a conglomerate's goal attainment traditionally have been primarily financially oriented.

This article presents the findings of an empirical study conducted in 1968 to determine conglomerate goals as top executives of six such companies view them[1] and to evaluate whether the indicators used to measure conglomerate goal achievement were proper or satisfactory for this purpose. It is possible for goal attainment measured by one index to show a success while if it is measured by another, or by multiple indices, it may show certain failures. Accordingly, whether a conglomerate's goal attainment was a success or not depends on the use of appropriate measurements and the weight given to each. For those who make decisions based on those indicators, the relative cohesiveness of such signposts to what they are supposed to indicate is important. Misleading financial decisions can easily be made if they are based on analysis that has used wrong indicators to measure the right parameters or used correct indicators to measure irrelevant parameters.

Goals of a conglomerate

On the basis of information obtained during interviews, conglomerate goals can be stated as follows:

Maximize sales subject to a profit per share constraint—Many conglomerates believe in a goal of maximizing sales volume subject to

Published by eGrove, 1970

Management Services: A Magazine of Planning, Systems, and Controls, Vol. 7 [1970], No. 3, Art. 7

> ***. . . it was found that, while mergers serve management interest (pride of building an empire from scratch), management believes that they also benefit stockholders through a rapid growth of profit per share and a sharp rise in stock prices.***

a progressive growth of profit per share constraint. This is resolved into a profit constraint for each subsidiary or division based on a budgeted rate of return on assets and/or a rate of return on sales. Goals and constraints are not synonymous. Many conglomerate presidents stated that they want to achieve a one-billion-dollar sales figure with no mention, for example, of achieving a 15 per cent net profit after taxes. However, their expectation is to have a profit level higher than that of the nonconglomerates.

Rapid growth rate—Merger and acquisition become a goal in themselves to supplement the internal growth rate toward the desired level of profit per share.[2] In many a conglomerate, the profit plan accounts for a specific percentage of its projected growth through acquisitions.[3] It was found that a conglomerate buys a company if the price is favorable, even if the purchase doesn't promise any immediate boost in earnings. The reason is that the conglomerate wants the assets so that it can borrow heavily against them and gain an important source of cash. Such a conglomerate has another strict policy that "no more than 10 per cent of net profit will be in one industry."

Merger activity by conglomerates, however, is believed to be carried out for reasons other than profitability, leading to conflict between the interest of stockholders and that of management.[4] Conglomerate management interest is to achieve individual prestige, personal satisfaction, and the power to meet management ambitions. For example, the president of Monogram Industries (Mr. Stone) states that empire building and personal attitude are the explanation for many acquisitions, rather than profitability.[5] Also, the president of Litton (Mr. R. Ash) states that "when they (conglomerate companies) stop making acquisitions, they probably won't be regarded as conglomerates and will merely be considered alongside other already matured and well-structured multi-industry companies."[6] The theme becomes not why so much merger, but, rather, why not more merger? In personal interviews with top conglomerate officers, it was found that, while mergers serve management interest (pride of building an empire from scratch), management believes that they also benefit stockholders through a rapid growth of profit per share and a sharp rise in stock prices. (This point will be discussed later.)

Strengthening conglomerate power—Conglomerate power is divided into two parts: (a) *market power*: If a conglomerate possesses market power in some markets, such power becomes a vehicle for the achievement of market power elsewhere, and (b) *conglomerate financial power* enables it to use profits earned in one of its constituent parts to subsidize its expansion in certain markets more powerfully than nonconglomerate companies.[7] From evidence in personal interviews, this latter power has been the most rewarding for a conglomerate.

Maintaining entrepreneural spirit—A flexible conglomerate structure is advocated to provide more decentralized and motivational forces than exist in other companies.[8] For example, the organizational structure of some conglomerates is based on separate subsidiaries that, in many cases, are not 100 per cent owned by the conglomerate. Strategy and control are central-

MOHAMED ONSI is associate professor of accounting at Syracuse University's College of Business Administration. He received his baccalaureate with honors from Cairo University and his M.S. and Ph.D. from the University of Illinois. Dr. Onsi instructed at both universities he attended and then taught at Fresno State College, California, before going to Syracuse. He currently is educational director of the Syracuse Chapter of the National Association of Accountants and a member of the Ad Hoc Committee of the American Accounting Association. In 1967 he received the NAA's Distinguished Manuscript Award.

https://egrove.olemiss.edu/mgmtservices/vol7/iss3/7

2

ized in a relatively small number of top management groups, while operations are highly decentralized. Headquarters officers are expert "trouble shooters" and specialists who provide the acquired companies with the expert opinions that enable the unit to achieve greater growth.[9] The conglomerate top management, in reality, acts as a "management consultant" with directing power. Such a managerial asset, management asserts, is the hallmark of a conglomerate and a thing that it looks for in acquiring companies. As a president of a conglomerate put it, "A conglomerate can take any unprofitable company and turn it to profit in two years." To maintain such managerial talent, the conglomerates have the most generous compensation bonuses in industry.

Stability—This goal is achieved through a system of diversification, e.g., a cyclical business is offset by a counter-cyclical one. Using the "project redeployment concept,"[10] a conglomerate reduces its dependence on any one product, technology, or business. This goal influences the acquisition program and, accordingly, the profit level.

Aggressive risk taking—Conglomerate management is willing to take, more often, a high degree of risk that either pays off by a substantial return or, alternatively, earns practically no profit. This managerial attitude is encouraged by the fact that another merger will come in very soon and that the total aggregate will not disclose a bad result. This attitude is supported by observation of the fact that the projects selected have different mixes of risk and return characteristics.

It should be noted that the above goals are interdependent and, as such, could be classified as major goals and secondary ones. For our purpose, this is of lesser importance. Also, there are subgoals that a conglomerate establishes for its subsidiaries or divisons. Such sub-goals, established in budget manuals, are consistent with the goals of the mother organization and are more specific and quantifiable. They are used as a basis for developing the subsidiary budget. For our purposes here, such sub-goals will not be commented upon.

Evaluating conglomerate goals

A. *Does a rapid merger-acquisition system yield high profit and rapid growth?*

It is difficult to know how much of the profitability of a conglomerate is based on improved products and efficiencies and how much reflects the attractive arithmetic of acquisition. The total profitability growth comes from three sources: (a) internal growth of the original divisions, excluding artificial growth due to inflationary trends, (b) external growth stemming from acquired or merged subsidiaries during the year, and (c) artificial growth due to accounting measurements such as those emerging from "pooling of interests" vs. "purchase," in addition to the impact of different accounting methods that may contribute to this artificial growth of net income.

Conglomerates amalgamate these three sources of growth together into one figure that does not disclose the materiality of each source or its trend. This makes it difficult to evaluate the validity of the assertion of so many conglomerate presidents who boast publicly of the wonderful turnaround of profitability of many of the acquired companies.[11]

While conglomerates attempt to iron out any anticipated difficulties of merger or any problems immediately arising after acquisition to improve profitability,[12] the turnaround is not always accomplished, and the merger financially may prove to be less than successful. The following observations support this:

a. In many cases, conglomerates pay a high price for the acquired company, thus earning a low rate of return on the investment. Since this merger achieves growth in

Conglomerate management is willing to take, more often, a high degree of risk that either pays off by a substantial return or, alternatively, earns practically no profit. This managerial attitude is encouraged by the fact that another merger will come in very soon and that the total aggregate will not disclose a bad result.

Published by eGrove, 1970

sales and assets, however, the merger is considered acceptable. In addition, merger in conglomerate companies is financed by issuing either preferred stocks or/and debentures, but not common stocks, unless management knows that the acquired company has a high probability of yielding not only a high sales volume but also a high profit rate. Lear Siegler has a policy of not issuing common stock unless profit per share issued is estimated to be at least one and a half times the earnings per share of the conglomerate's fiscal year. G & W requires that new acquisitions must promise at least 10 to 12 per cent return on investment and that the acquired company should not have a price earnings ratio higher than its own. This last point is very important, since, if a conglomerate has a P/E ratio of 40, it will be able to buy a company for an overestimated price, equal, for example, to 30 times its P/E.

b. Many conglomerates acquire firms of larger size than themselves, resulting in a sudden expansion of the acquiring firm that may be less profitable than a step-by-step expansion subject to repetitive re-examination of costs and benefits for each additional increment of growth. In many cases, the increment of expansion through mergers is too large for the conglomerate to control effectively, and increases in cost may result rather than the expected economies. Cost increases are least likely to affect profit in a firm which makes a large number of acquisitions, and the timing of their reflection on earnings will not be immediate in the short run due to the ability of the conglomerate to absorb losses higher than nonconglomerates can absorb.

c. In many cases, the acquired company has a product that is good, and competitive for the time being.[13] However, the acquired company may be technologically obsolete in the near future. In other instances, the company may have been created by an individual who is going to retire in 1 to 3 years, during which period his managerial effort relaxes, and then the acquired company may become less profitable. This is the case in many of the new conglomerates.

d. Conglomerates' mergers and acquisitions have shown higher failure figures than other companies',[14] which proves that either: (i) The conglomerate management did not have time to study and evaluate the future of the acquired company before its merger, or (ii) the conglomerate management knew about the expected failure of the acquired company, but gambled heavily on its own overestimated managerial capability to turn it into a profitable one, or (iii) merger is used as a hedge to counteract the decline in profitability in one year, even if it means the acquisition will add problems later. This is to say, for short-term considerations, acquisitions are made even if they are bad for long-term purposes, and (iv) in many cases where mergers were made to enable the conglomerate to "make" the product instead of "buying" it, the analysis used ignored many intangibles that were "critical" for the intermediate term.

Finance mergers pay off best

The biggest dollar payoff from synergistic effects after acquisition, however, resulted from finance mergers, followed by marketing mergers, followed by technological mergers, and, finally, production mergers. This explains the new tendency of conglomerates to acquire insurance companies. The reason that synergistic effects in the fields of production and technology do not rank high is that the conglomerate acquires companies with different sizes of production and different technological skills, so that significant economies of scale may not be achieved.

B. *Is a conglomerate company more efficient than a nonconglomerate?*

Conglomerates are generally not more or less efficient than other types of corporations of equal size. No significant difference was found between the management control system of conglomerates and some of the well established, large companies that are nonconglomerate. However, there was some evidence in favor of the conglomerate in terms of motivation, through its use of generous incentive compensation. The evidence that this motivational impetus induces a higher level of performance is not, however, conclusive.

Distinction should be made between (a) the efficiency of the conglomerate's individual plants (i.e., *plant economies* or economies of mass production) and (b) the *added economies,* if any, resulting from the operation of several units under common management (administrative economies of scale). The *first economy* is a function of size, e.g., the optimum size beyond which further expansion will result in diminishing returns. The *second economy* is a function of the possibility of having economies in such areas as distribution, overhead, and research vs. the possibility that such advantages may be offset by cost increases stemming from duplication of staff, problems of communication, managerial gap, slow response to changes in markets or supply, and the lack of flexibility implied by central controls over hundreds of plants.

Efficiency, in its economic meaning (e.g., most effective utilization of the means of production leading to producing a certain quantity with the least expenditure) is not easy to measure in a conglomerate.[15] As a substitute, top management of conglomerates assumes that profitability is a measure of efficiency (i.e., profitability reflects economic efficiency).[16] Conglomerates have worked hard to convince stockholders, investors, etc., that the high profits earned reflect their high level of efficiency.[17] This, in reality, is not true. A conglomerate that has sufficient monopolistic power in one of its markets may be extremely profitable, but not

https://egrove.olemiss.edu/mgmtservices/vol7/iss3/7

necessarily because of its efficiency or cost reductions. Conglomerate companies have ignored the distinction between financial efficiency and economic (or real) efficiency.

The assumption that control of plural production units by a single conglomerate contributes to efficiency would seem to rest upon an overwhelming absence of supporting facts. To the contrary, the individual unit is likely to become less efficient than that owned by a company concentrated in one field. Conglomerate management competence gets diluted by proliferation into strange industries, and the stranger the invaded industry the greater the dilution. The more foreign to the conglomerate technology and competence the acquired company, the poorer management efficiency will be.

Evidence cannot be dismissed that the earnings of the separate units before merger on the average were greater than the earnings of the same units after consolidation, as shown in some empirical studies.[18] This may be due to "managerial gap" (or/and "motivation gap") between the competence of the conglomerate's top management and the individual unit. This is the reason that many conglomerates transfer a headquarters officer to the acquired units. Many conglomerate officers have stated that it takes from three to five years to integrate such a unit into the total conglomerate control system and turn it into a profitable or highly profitable one.

Gulf & Western Industries states that "the average operating subsidiary of G & W has achieved a compound annual growth rate of 15.9 per cent in operating profits; and the most recent internal earnings growth, from fiscal 1966 to fiscal 1967, shows an internal profit after tax increase of 18.5 per cent."[19] If it is assumed that these figures are indicators of the internal growth of this company, one may ask if this is a measure of management efficiency. Accounting profit is not a valid indicator of management efficiency for the following reasons:

1. Divisional high profit may not be the result of greater economic efficiency, but due rather to a certain degree of monopoly—especially for companies in a highly technological area where research is the dominant factor.

2. Earnings per share in a particular year can be legitimately controlled within certain, quite broad, limits, e.g., "income management. Cost allocation, transfer pricing, inventory valuation, . . . etc.," are used as tools in the hands of management to provide a "managed income" figure. For example, allocation of headquarters expenditures to subsidiaries in one conglomerate is based on how much top management wants profit per share of this subsidiary to be.[20] As the head of a conglomerate put it, "What you want is a nice, steady rise in per share earnings—*no surprises*, especially on the downside."

3. Conglomerate financial power contributes significantly to high profitability (more than in nonconglomerate cases and more than that attributable to conglomerate economic efficiency) due to low costs of materials, a reflection of buying power, and due to low overhead. These are reflections of economies of multiple operations, and not necessarily economic efficiency.

For the above reasons, one is led to believe that the profit figure, as measured today for a conglomerate, is not a meaningful figure, unfortunately. In addition, measuring profit by major product line, while a meaningful step, falls short of solving the problem. If the accountant and SEC want to provide an index of management efficiency, an accounting figure is a weak indicator. More than one index is needed. A meaningful approach to pinpoint management efficiency would be to disclose publicly budgetary data for each major product segment of a conglomerate and compare them with actual achievement. Other indices, in addition to accounting profit, could also be disclosed, providing meaningful measures of other dimensions of management efficiency.

C. Does a conglomerate's high-risk-taking attitude pay off?

The risk in conglomerate activity is very high. For example, in an empirical study of acquisitions, it was found that 45 per cent of the total acquisitions investigated consisted of the conglomerate type, and 42 per cent of all the failures occurring were in the conglomerate group.[21] This suggests the conclusion that conglomerate risk reduction (as assumed) evidently bears its own risk. The reason for such high risk is the possibility of deficiencies in the planning and control system of a conglomerate. Conglomerate top management, in many cases, does not know the changing activities of its subsidiaries, and, as a result, it pressures the divisional unit into activities that seem attractive and profitable, but for which the unit is not ready. In addition, control procedures in a conglomerate emphasize financial measures on a monthly basis, in total aggregate, that may not pinpoint any underlying troubles for some time. When such measures reveal the failures, it is too late. Our interviews showed that the control systems of conglomerates are widely varied, some good and some bad. Even in those conglomerates with good management control systems, there is no significant difference between the quality of these systems and those of some large companies that are nonconglomerate.

Risk taking, however, differs among organizational levels. A conglomerate's top executives may be perfectly willing to risk millions on a project where the chances of success are low, but the potential rewards are very high. Failure in some projects, due to averaging, won't materially hurt the conglomerate. But since a divisional manager is under pressure to produce divisional profits to keep his bonuses up, he is more likely to favor low-risk projects.[22] However, in one conglomerate, risk taking was found to differ widely among subsidiaries or major divisions, i.e., the risk-taking attitude of a movie

production division is different from that of a cigarette production division.

Conclusion

From interviews with several executives of conglomerate companies in the summer and fall of 1968 and other material obtained, it can be said that conglomerates have used the wrong indicators to measure the attainment of their goals, especially the profit goal.

There is no evidence to support the hypothesis that a conglomerate company is more efficient than a noncongiomerate. Such a hypothesis is rejected because the difference in efficiency level between conglomerates and nonconglomerates was not significant. There was a wide variation in the efficiency level between conglomerates, which proves that they show the same pattern of behavior by industry, size, product, classification, . . . etc.

Profit per share is a poor indicator of management efficiency. In a conglomerate, reported profit is the result of many factors, some of which are more important than others. Profit increase, as a result of mergers and financial economies, contributes significantly to total conglomerate profit. If these two factors do not exist, the conglomerate is likely to lose a large part of the claimed profits. The attitude of the accounting profession in measuring profit per residual share is a step in the right direction. However, such a step is far too limited in dealing with the complicated problems of generating indicators to measure the efficiency of conglomerate management.

The proposal mentioned above of publishing budgetary data would be a long stride forward in that direction.

---

[1] A conglomerate is a company operating across a number of different unrelated economic markets, and the mix of its market is constantly changing. This issue, however, is not critical for our purpose here since the companies interviewed are the leaders of the conglomerate movement and would be described as such under any definition.

[2] This is evidenced in the period 1960-66, when 72 per cent of all types of mergers were conglomerate in nature. See: "Selection and Opinion," *Value Line Survey*, April 28, 1967, p. 468.

[3] For example, see the views of the executive vice-president of Lear Siegler, a conglomerate, Robert L. Purcell, "Building a Conglomerate Company," *Financial Executive*, March, 1968, p. 20.

[4] A relationship between sales and executive income, but not between profits and executive income, is found. For example, doubling company size increases compensation to top management by about 20 per cent. See: A. Patton, "Deterioration in Top Executive Pay," *Harvard Business Review*, November-December, 1965, pp. 106-118. Patton notes that in 1964, 60.8 per cent of the variance in top executive pay was explained by differences in company sales. Since sales growth (rather than profitability) is such an important variable in determining management's income, there is a conflict between management interest and the stockholders' interest. See also: McGuire, Chin, and Elbing, "Executive Incomes, Sales and Profits," *American Economic Review*, September, 1962, pp. 753-761; D. R. Roberts, *Executive Compensation* (Glenmore, 1959); and S. Reid testimony before the Subcommittee on Antitrust and Monopoly, Economic Concentration, Part V, pp. 1919-1934.

[5] *The Wall Street Journal*, August 12, 1968, p. 13.

[6] *The Wall Street Journal*, July 25, 1968, p. 8.

[7] It should be recalled that conglomerate power is used in various ways to promote the welfare of the conglomerate, even at the expense of rivals and in ways detrimental to competition. While antitrust laws may deal quite effectively with the conspicuous uses of conglomerate-derived power, they may be powerless in dealing with subtle competitive strategies.

[8] The president of Gulf and Western, a conglomerate, has stressed the conglomerate's managerial superiority over other corporate structures. He said what is important is the approach, the concepts, the make-up, the talents, and the track record of management. See: David N. Judelson, "The Role of the Conglomerate Corporation in Today's Economy," *Financial Executive*, September, 1968, p. 20, and "A Philosophy For a Conglomerate Company," *Business Horizons*, June, 1968, pp. 7-13.

[9] See: Joseph G. Bacsik, vice-president and controller, Ling-Temco-Vought, "The Ten Commandments . . . Company Objectives and the Budget Plan—in a Large Organization," a paper presented at an American Management Association meeting March 18, 1968.

[10] See Ling-Temco-Vought, Inc., *Annual Report*, 1967, p. 3.

[11] For example, see Judelson, *op cit*

[12] See: Joseph G. Bacsik, "Ironing Out Post-Merger Difficulties," a paper presented to a seminar, "Current Problems in Financial Management," National Industrial Conference Board, May 15-16, 1968, San Francisco, California.

[13] Several mergers became substitutes for research when it was a matter of getting into new fields of technology and new products.

[14] See: John Kitching, "Why Do Mergers Miscarry?," *Harvard Business Review*, November-December, 1967, p. 91.

[15] Managerial efficiency in a conglomerate measured by an accounting profit figure will be at a test during the downward cyclical phase or when merger activity slows down to almost nil. This may be the case in 1970.

[16] Many top executives in conglomerates state that they judge the efficiency of each subsidiary or major unit in total aggregate by the ratio of pre-tax profit to sales. Other ratios and analyses of deviation are calculated as in any other company.

[17] Many references can be cited. However, see: David N. Judelson, president of G & W, "The Conglomerate as The New Economic Frontier," a paper read before the Continental Assurance Company, September 11, 1968, and his address before the Investment Analysis Society of Chicago, October 17, 1968.

[18] Arthur S. Dewing, "A Statistical Test of the Success of Consolidation," *Quarterly Journal of Economics*, November, 1921. While the data used by Mr. Dewing are far in the past, the facts of business reality in the 1960's show similar patterns in the case of business conglomerates.

[19] *op cit* p. 23.

[20] In addition, profitability of each subsidiary is influenced by the process of allocation of capital that in turn acts as a filter to minimize the impact of a downtrend in a certain subsidiary's profit.

[21] Kitching, *op cit*

[22] To reduce such conflict, the establishment of a norm or standard which allows a divisional manager a certain proportion of failures is likely to encourage him to take on more risky projects. This does not mean that failures are encouraged; it merely means that success on every project should not be weighted so highly by top management that not enough high-risk projects are undertaken. If "good performance" is equated with a low failure rate, this will encourage a behavior that is not in the best interest of the company, as shown above. See: Norman Berg, "Strategic Planning in Conglomerate Companies," *HBR*, May-June, 1965, pp. 83-84.