Journal of Accountancy

Volume 46 | Issue 1 Article 2

7-1928

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Recommended Citation

Couchman, Charles B. (1928) "Accounting for Mergers," *Journal of Accountancy*: Vol. 46 : Iss. 1 , Article 2.
Available at: https://egrove.olemiss.edu/jofa/vol46/iss1/2

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# Accounting for Mergers*

By Charles B. Couchman

Much has been written regarding the limitations that properly bound the scope of an accountant's work, but the modern trend of business activity and the increasing measure of confidence placed in the accountant's judgment as to matters appertaining to various phases of commercial activity have pushed back these boundary lines to a great extent. Accountancy is not alone a matter of measuring and recording values, but it also involves the study of their relationships. The accountant who too rigidly limits the scope of his activity may fail to give to his clients the full value of his service. This is not intended to indicate that the accountant should at any time go outside his proper realm; but rather that the accountant should know and understand the service that he is, or should be, qualified to render as an advisor along accounting and financial lines.

This thought is being emphasized at the present time because of the activity in reorganizations, refinancings, mergers and consolidations that are an accepted part of the business routine of today. Each such activity necessitates careful thought and the utilization of much experience if it accomplishes best results for the commercial organizations involved.

Heads of many concerns today are giving consideration to one or more of the above activities. A mere audit and presentation of past results does not give to such men all of the aid which they need in deciding their problems. They are entitled to the benefit of the experience and opinions of accountants with regard to the relative desirability of the various plans which they are considering and to their aid in working out the most favorable solution of such problems.

This address is concerned primarily with the subject of mergers and consolidations. The accountant for any organization considering forming or entering into such a deal has an opportunity of rendering to his client a far greater service than mere routine auditing.

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*Address delivered at the annual meeting of the Michigan Association of Certified Public Accountants, Detroit, Michigan, May 25, 1928.

Consideration must be given, first, to the advantages that may be effected by such a union of companies taken as a whole, and, second, to the advantage or disadvantage resulting to the particular concern or concerns served by the accountant.

### PURPOSE OF MERGERS

Mergers or consolidations arise chiefly from attempts to accomplish some of the following:

1. To stabilize the industry
2. To reduce competition
3. To reduce expenses
4. To effect more efficient financing

*Stabilizing an industry*

An industry frequently suffers from the lack of effective coöperation of the companies concerned in it. Production may exceed the proper needs of the public. Raw materials may not be produced efficiently or may be of inferior quality because of lack of facilities, of finance or of control. In some businesses there is a tremendous amount of unnecessary trans-shipment. Goods produced in one section are sold in a second and goods of the same general character produced in the second are sold in the first. This trans-shipment may affect not only finished goods but raw materials. In some industries the various processes through which raw material must pass until it is ready for the consumer may be under the control of so many unrelated concerns, each of which must make a profit on its operations, that the finished goods are not furnished to the consumer at a price consistent with a proper economic ratio. Any or all of these faults may at times be corrected by a proper merging of various activities under a centralized control.

The bituminous coal industry is an excellent illustration of the lack of control over production. A well devised consolidation of leading mining companies in the bituminous field should result in better working conditions for the miners, in a better stabilized price to the coal user and a more efficient meeting of the latter's needs, and yet produce a reasonable return upon the capital invested. Similarly in certain other businesses a consolidation of numerous concerns should result in building up a control over the raw-material fields, and in the introduction of proper equipment and of scientific methods of production that would greatly increase the quality of the material and therefore of the finished product, without working any hardship upon any of the parties concerned. At the same time consolidations might produce better living conditions in the raw-material fields without increasing the price of the finished product.

Shoes manufactured in New England are sold in the Mississippi river territory and shoes of the same quality manufactured in the Mississippi valley are sold in the New England territory. Certain types of machinery manufactured in the eastern states are sold in the middle states and machinery of the same character manufactured in the middle states is sold in the eastern territory. All this shipping cost must of necessity be borne ultimately by the consumer. In a certain industry the raw material passes through seven processes, each performed by a distinct corporation before reaching the consumer. In the same industry there are corporations which by consolidating these activities produce the raw material and sell the finished product directly to the consumer, thus through efficient methods producing either a greater profit per dollar of investment or a lowering of price to the consumer for the same standard of product.

*Reducing competition*

There are businesses at the present time in which comparatively limited numbers of factories compete constantly with each other in bidding up the price of the rather limited supply of raw material and then again compete with each other in bringing down the selling price to the consumer. While in one case I have in mind this may result in some benefit to the community by lowered price, it has resulted in two disadvantages, namely, the producers of raw material, realizing that they can dictate their terms to the factories, have made no effort to improve the quality or to introduce scientific methods of production. Working conditions under their control are far from meeting the ideals of humanitarian thought. The factories because of such double-barreled competition have not been able to make a profit justifying proper financing to develop modern methods and equipment. As a result of these combined conditions the product has not kept pace with the development in other classes of manufacture.

While competition is a most desirable element in commercial life, it can be carried to such an extreme that the public suffers rather than benefits because of it.

Again, in many fields new firms are continually arising which do not properly understand their costs and therefore undersell legitimate competitors as long as their finances enable them to exist. Their ultimate failure seems only to result in other concerns of similar character springing up, living their short life of competition, and then passing into bankruptcy. While it may seem that the public benefits by securing products from such concerns at a price less than true cost, it must be remembered that all such losses are passed on in some form to the buying public which ultimately pays the cost of disturbing elements in business life.

*Reducing expenses*

Legitimate reduction of expenses frequently results from correctly planned merging of concerns. Managerial expenses may be lowered through having fewer and better executives. Purchasing costs may be reduced by the increase of purchasing power, by contracts for entire outputs of various concerns and by decreasing the number of purchasing departments. Similarly selling costs may be reduced by consolidating display rooms, by centralizing advertising, by reducing the duplication of salesmen in a given territory and by a broader capitalizing of recognized trade-marks.

Operating costs may be lowered by providing more efficient department heads, by a broader use of methods that have been found most efficient, by unification and better utilization of equipment, and by improved quantity production.

An important element in the tremendous progress that has been made in industry has resulted from systematic and scientific research work. In this respect smaller organizations are frequently greatly handicapped. A consolidation of companies may result in the development of a more efficient and economical research department, the benefits of which may apply to the whole group and may result in the production of an improved quality of output.

Financing cost may be decreased greatly if the consolidation has sufficient capital to reduce to a minimum the cost of money which it uses, by decreasing total inventory investment and by increasing the turnover of current assets.

These are merely the more important of the various reductions which may be made in the cost of producing finished product.

If legitimate competition in the industry is still maintained the advantages noted must be passed on to a certain extent, at least, to the benefit of the community at large through lowered costs and improved and unified products.

*Refinancing*

There are times when it is necessary for a corporation to reorganize its financial structure. This may be due to an initial structure not properly balanced or it may be due to changed conditions of such a nature that its financial demands have grown out of proportion to its abilities. It may be facing the maturity of a security issue which it is not prepared to liquidate. It may be top-heavy with liabilities, or the capital-stock issues outstanding may not be in proper ratio to its resources or to its need for expansion. A corporation may face the necessity of financial reorganization even though its profits are excellent. The accountant should be sufficiently versed in the subject of financial structure to render helpful advice as to the best method to be pursued in meeting such a need.

## THE ACCOUNTANT'S FUNCTION

It is part of the legitimate function of the accountant to advise when called upon with regard to the advantages of merger and also with regard to any disadvantages which may result in a specific instance. He should be qualified and should be free to give such advice so far as it comes within his proper realm. This, of course, does not imply that the accountant should consider himself an engineer, nor an efficiency expert, nor should he intrude in any way upon those fields where his knowledge of necessity is superficial and is not based upon thorough experience as to what the results of his opinions would be. Even with this limitation, however, there is a broad field where his judgment should be of value to the one who is giving consideration to forming a consolidation or to entering into a group.

*Plan of organization*

The accountant should be much interested and should have an advisory part in the formation of the financial plan of the new organization. Frequently his experience and judgment form a valuable aid to the development of a financial scheme that will be basically sound and will harmonize with the expected profits of the new concern. Many an organization has been created, even with the help of its various brokers and underwriters, which has contained serious faults that could have been foreseen and pointed out by an able accountant. In acquiring ownership of a corporation one or the other of two methods is commonly followed. The methods are distinct and differ greatly in their results, yet frequently the two are confused in the minds of business men who do not recognize the distinction between them.

Under one method the capital stock of the corporation is acquired, thus giving control over the assets.

Under the second method the assets are acquired by direct purchase, the stock remaining in its original ownership.

Under the first method the purchasers of the stock acquire the ownership of the original corporation including not only control of its assets but assumption of its liabilities, actual and contingent. There are times when this is the preferable method, as all goodwill or other attributes innate within the original corporation are acquired through the stock ownership. Under the second method purchase is made of assets as specified in the agreement and if the agreement so provides all or part of the liabilities may be assumed. Payment is made to the original corporation and it may then liquidate by distribution to its stockholders of the purchase price and of any assets not transferred. Under this method the buying company does not acquire the original corporation and therefore does not acquire any asset save those specifically transferred by the agreement. Neither does it assume any liabilities that are not covered by the purchase agreement. Any such liabilities that may exist or that may appear after the transfer are the liabilities of the old corporation and should be met by it prior to its distribution to its stockholders. There are times when this method is preferable from the viewpoint of either the selling corporation or of the buyers.

The accountant for the selling corporation as well as the accountant for the buyers must be made aware of the exact character of the transfer and of all its details. Otherwise the resulting entries on the financial records may not be in keeping with the true facts. Every accountant in public practice has probably seen cases where there was a marked discrepancy between the legal transactions and the transactions as recorded in the financial records, due to a misunderstanding of the exact nature of the contract of transfer.

When several companies are consolidated into one ownership unit the method of payment for each usually varies according to the character of the assets acquired. These assets may be roughly grouped under three headings and the method of payment usually varies with regard to each group. The three groups may be referred to as, first, current-working-capital group; second, fixed-asset group; and third, goodwill and other intangibles.

Ordinarily the payment for the first group must be either in cash or in some form of security of a fairly liquid nature, or a combination of the two. The payment for the second group ordinarily is made by some form of long-time security either in the nature of a bond or of a preferred stock. Payment for the third is most commonly made by common stock of the new corporation. As the value of this group of assets depends largely upon its earning power, over and above a fair return on the cost of other assets, it is proper that the method of payment should be such that the income should be in the nature of dividends paid out of earnings after the financial requirements of the other forms of securities have been met.

Considering the consolidation as a whole, the accountant should see that the method of payment for each unit should be such that the consolidation will be properly balanced as to cash, other current assets, fixed-asset investments, liabilities and other outstanding securities. The financing plan of the consolidation must be such as to provide for the purchase of the various units and provide sufficient funds for proper operation without unduly burdening future operations by fixed charges or dividend requirements.

*Accounting work*

The payment for each unit absorbed must be in keeping with the ratio of value which that unit contributes to the consolidated whole. This necessitates uniformity so far as possible in the valuation of the various elements of each unit and its worth to the consolidation.

Fixed-asset value is usually determined by appraisal. Most commonly this appraisal for purpose of settlement with the individual companies is made on the basis of sound value, that is, reproduction cost less accrued depreciation. For internal purposes of the consolidation these assets may be revalued upon the efficiency basis although the latter is seldom used for determining the purchase price.

The determination of other assets and of liabilities is commonly made by the accountant on the basis of routine audit. This as a rule presents few complications, with the exception of the inventory which is discussed later. If the purchase price, or a variation in the character of the securities used in payment, depends upon the classification of the assets and of the liabilities, the accountant should have the approval of the purchasing parties with regard to the exact content of such classifications. Among the items to which consideration should be given are prepaid expenses, deferred charges, investments, supplies, etc. With regard to liabilities there must be some definite basis to serve as a dividing line between current liabilities and others that are not to be so classified.

There is an increasing tendency to classify prepaid expenses among the current assets and the reasons for such inclusion are sound. Supplies in the nature of replacements of machinery and equipment may be grouped for this purpose as a subdivision under fixed assets, whereas other supplies may be grouped among the current assets. The complications of this character to which consideration must be given are too numerous for detailed discussion here.

The question of the accountant's proper responsibility for inventory has been the subject of much discussion. The accountant may be properly held responsible for accuracy of inventory count, and of extensions and footings. I hold, however, that it is very doubtful if accountants in general are qualified to pass upon the character, the condition or the pricing of many classes of inventories. They can not be expected to have accurate knowledge with regard to all the technical gradations of merchandise in its manifold forms. Neither can they pass upon the condition of many classes of inventory items unless they possess a highly specialized training in the particular industry involved. As an illustration, give consideration to an inventory of chemicals. Even the most able accountant might be and probably would be utterly at a loss to identify properly the various items in such an inventory. To depend upon a label would be letting down the bars to all forms of inaccuracy. The same may be said of countless other classes of inventories found in modern business. I hold that for the purposes of purchase the classification and the grading of inventories must be placed in the hands of technicians of the particular industry involved. Needless to say these technicians should not be a part of the organization owning the inventory. It is sometimes found practical to appoint a committee among the various parties to a proposed consolidation which will lay out a scheme of classification and employ disinterested technical men to identify the various inventory items. This committee may also decide upon a price schedule applicable to each classification. The mechanical portions of inventory-taking may properly be performed by the accountant.

*Determining value of intangibles*

Since the earning power of a business has a marked effect upon its sales value, entirely aside from the intrinsic worth of its tangible assets, the determining of such value forms a major part of the accountant's work in the transactions which we are considering. Usually the sponsors of the security issue desire an earnings statement for a number of years preceding the date of consolidation. With regard to each unit these statements are usually prepared on two bases: (a) the earnings as recorded, with such adjustments as the accountant finds necessary in the course of his investigation; and, (b) a statement of adjusted earnings wherein the figures as shown by the accounting records are adjusted for the purpose of establishing as between all the units certain uniformity with regard to expenses that are more or less of an arbitrary nature. These expenses include such items as the following:

1. Managerial salaries
2. Capitalization of fixed expenditure
3. Depreciation
4. Profit or loss on the sale or other disposition of fixed assets

and the like.

Managerial salaries, particularly in close corporations, are usually arbitrary and are frequently fixed at as high a figure as will be allowed by the internal-revenue department. Some method of establishing uniformity in this item must be determined by the purchasing body. Items of expense related to fixed assets may best be determined by a retrospective appraisal which will establish the proper additions to fixed assets for each year and the proper depreciation for each year. This method establishes a uniformity with regard to all companies concerned to supplant the methods used in the individual companies, which usually reflect on one hand the desire of a corporation to show a profit and on the other hand a desire to save income taxes. In determining the true earnings for the purpose of calculating value of intangibles a company should not be penalized because of the conservatism of its management nor should it be handed a bonus because of a treatment far from conservative.

Another element that may enter into this modification of earnings involves the question of non-recurring charges, such as unusual losses and unusual expenditures not necessitated by the operation of the company.

The accountant may also be required to prepare a statement of prospective earnings of the consolidation. Such a report should be based upon past performance adjusted by such modification of expense as may be determined by the management of the consolidation, such as managerial salaries, depreciation and items of a similar class already discussed, together with changes in financing expense in keeping with the requirements of the scheme of capitalization of the consolidation. Since such a statement does not show past or present facts but only expectations, it can not be certified and preferably should not appear over the signature of the accountant. It is at best a mere guess and while of value to the parties issuing securities, it is not within the scope of recognized accounting reports. I do not intend to convey the thought that the accountant should not prepare such a statement if asked. I merely intend to emphasize again the fact that an accountant's certificate must deal with past or present determinable facts.

There has been no attempt in this address to give a technical or an exhaustive treatment of the subject matter, but rather to point out the various activities which the accountant is called upon to perform in these days of extensive reorganizations, mergers and consolidations. The accountant is being consulted more and more with regard to the effects of the various elements within his realm in addition to his function in verifying and summarizing the results of what has been. His advice is more frequently sought with regard to what should be done. More and more he is being asked how to produce desirable results and avoid undesirable ones, instead of being held merely to pointing out what should have been done after it is too late to change the conditions.