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OBJECTIVES OF FINANCIAL REPORTING, ABORIGINAL COST, AND POOLING OF INTERESTS ACCOUNTING

Abstract: Through the years, pooling of interest accounting was criticized as contrary to the decision usefulness objective of financial reporting and potentially misleading to stockholders and creditors, the assumed principal users of financial reports. This paper does not dispute those criticisms. It demonstrates, however, that there were some very good reasons for permitting pooling accounting for certain business combinations when the method was developed in the 1940s. At that time, the basic objectives of financial accounting encompassed stewardship and decision usefulness for multiple users, including public utility regulators and public policy makers. Pooling accounting developed in part to satisfy the information needs of public utility regulators who favored aboriginal (original historical) cost to determine the utility rate base; additionally, it was favored by public policy makers who sought lower utility rates (prices) to foster social and economic goals.

INTRODUCTION

Most academic and practicing accountants are familiar with the recent theory controversy over the financial reporting of business combinations. A major part of this controversy centered on whether to continue to require or permit *pooling of*

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interests accounting under *Accounting Principles Board [APB] Opinion No. 16, "Business Combinations"* [APB 16, 1970] for business combinations brought about by exchanges of common stock. Pooling accounting was criticized as contrary to more basic accounting concepts [see, e.g., Wyatt, 1963, pp. 92-95, 105; Kam 1990, p. 379] and/or potentially misleading to external financial report users such as stockholders and creditors [see, e.g., Seligman, 1982, p. 420] and/or contrary to the stewardship and/or decision usefulness objectives of financial reporting [see, e.g., Martinez-Jerez, 2008, p. 6]. Among other defects, critics of pooling accounting [see, e.g., Briloff, 1967, pp. 490-495; Lintner, 1971, pp. 106-107; and Davis, 1990, p. 104] noted that it grossly understated (1) the cost of such combinations; (2) the carrying values of acquiree net assets at the combination date; and (3) the expenses from using up those net assets subsequent to the combination date.¹ The controversy was largely resolved in the United States by *Statement of Financial Accounting Standards No. 141, "Business Combinations"* [SFAS-141, 2001],² and internationally by *International Financial Reporting Standard No. 3, "Business Combinations"* [IFRS-3, 2004], which prohibited pooling accounting and required purchase accounting for all business combinations.³ For convenience, the subsequent discussion of accounting standards is in terms of U.S. GAAP.

This paper does not dispute these aforementioned criticisms of pooling accounting. Rather, it demonstrates that, from a historical perspective, there were some very good reasons for requiring or at least permitting pooling accounting for stock-for-stock combinations of public utility companies when the method was developed in the 1940s. At that time, the basic objectives of financial accounting were viewed more broadly than now to

¹Of course, corporate management of unregulated industries and their promoters often favored pooling accounting for these very reasons; it usually reported stock-for-stock combinations at lower book values rather than at higher fair values, thereby resulting in reporting lower expenses and higher earnings after the combination.

²Somewhat inconsistently, shortly after prohibiting pooling accounting for business combinations, the FASB prescribed a similar accounting method for certain combinations of not-for-profit organizations. However, the FASB refers to this prescribed accounting method as the *carryover method*, not the *pooling method*. See SFAS 164, 2009, paras. 6-7, in ASC Section 956-810-20.

³To harmonize terminology internationally and reflect some more recent changes in the way combinations are recorded, purchase accounting is now called the *acquisition method*. See *Financial Accounting Standards Statement No. 141 (Revised), "Business Combinations"* [SFAS 141(R), 2007a], in FASB Accounting Standards Codification (ASC) Section 805.

include providing information to a set of unknown users with multiple needs, not just stockholders and creditors; importantly, the basic objectives of financial accounting included providing information for rate making by utility regulators and for fostering certain social and economic goals by public policy makers. In the 1940s, some of the above enumerated defects of pooling accounting were viewed as strengths, at least by utility regulators and public policy makers.

More specifically, because it reported stock-for-stock combinations at historical cost book values rather than at usually higher fair values, pooling accounting conformed to the concept of aboriginal (or original historical) cost and prudent investment theory in utility regulation. As a result, it usually resulted in lower utility rate bases; in turn, the lower rate bases resulted in lower utility rates (prices), which were viewed as consistent with social and economic policies of encouraging more widespread use of electricity to facilitate economic growth and enhance living standards of the masses. The remainder of this paper is organized in the following sections:

- (a) Overview of tax and financial accounting for stock-for-stock combinations
- (b) Rate making information needs of regulatory authorities
- (c) Rationale of aboriginal cost for regulatory purposes
- (d) Rationale of pooling accounting for regulatory purposes
- (e) Changing perceptions of objectives of financial reporting
- (f) Summary and conclusion
- (g) Addendum: Recent combinations of health care organizations

OVERVIEW OF TAX AND FINANCIAL ACCOUNTING FOR STOCK-FOR-STOCK BUSINESS COMBINATIONS

Section 368 of the U.S. Internal Revenue Code (IRC) deals with business combinations, which it refers to as *corporate reorganizations*. Turnier [1976, p. 911] notes that since 1918, the IRC provides for nonrecognition of gain or loss on stock or securities received incident to nontaxable corporate reorganizations; since 1924, the IRC provides for carryover basis, whereby the tax basis of the old stock or securities becomes the tax basis of the new stock or securities in nontaxable corporate reorgani-

zations.⁴ Section 368 includes detailed tests as to what qualifies as a nontaxable corporate reorganization. Under Section 368, many if not most stock-for-stock business combinations are nontaxable corporate reorganizations, with the acquiree's tax basis of the stock or net identifiable assets carried over to the acquirer.

Until the 1940s, all business combinations, including nontaxable stock-for-stock business combinations, were subject to purchase accounting for financial reporting purposes. As a result, the acquirer reported the identifiable net assets of the acquiree at fair value for financial reporting purposes, with the residual reported as goodwill.⁵ On the other hand, nontaxable stock-for-stock business combinations were subject to carryover basis for tax purposes. Sapienza [1962, pp. 277-278] suggests that pooling accounting is merely an adaptation of the tax treatment of nontaxable business combinations for financial reporting purposes:

If a combination is accounted for tax-wise in one manner, namely [with carryover basis] as [a] pooling, and as a purchase in financial reports, pressure to create an accounting method to conform to the tax law arises. The concept of pooling is the natural outgrowth.... It is the author's [Sapienza's] view that the pooling concept in accounting ... results, in part, from tax law. The pooling

⁴Turnier [1976, p. 911] suggests that Congress granted nonrecognition of gain or loss for qualifying reorganizations principally from "... a desire not to discourage economic restructurings which otherwise would have occurred in the course of the orderly evolution of the nation's economy." He [1976, p. 911] notes that from 1921 to 1924, the Code inadvertently permitted basis step up even though it permitted nonrecognition of gain or loss.

⁵Until 1953, acquirers could write off goodwill immediately against additional paid-in capital for financial reporting purposes. Additionally, until 1953, some acquirers reported some or all of the difference between the book value and the fair value of the acquiree as goodwill when it was impracticable to allocate that difference to individual identifiable tangible and intangible net assets, with just the residual reported as goodwill. See Wyatt, 1963, pp. 30, 38-39. (However, this practice was presumably more common for unregulated than for regulated companies, because regulated companies made every effort to allocate the difference in order to obtain a stepped up rate base.) Until 1970, acquirers could choose not to amortize unimpaired goodwill. See APB 17, 1970, para. 14. As a result, post-combination net income might be almost the same under purchase and pooling accounting. (Again, however, this result was more common for unregulated than for regulated companies.) Until 2001, some acquirers reported some or all of the difference between the book values and the fair values of acquiree identifiable intangible assets as goodwill rather than allocated those differences to individual identifiable intangible assets, with just the residual reported as goodwill. See SFAS 141, 2001, para. B162-B164.

concept allows parallel treatment in tax and financial reports, in accounting for business combinations.

The next section of this paper discusses the rate making information needs of public utility regulatory authorities. The heart of the paper is the following two sections that discuss, respectively, the rationale of aboriginal cost for utility regulatory purposes, and how pooling accounting developed as a logical outgrowth of the increasing use of aboriginal cost for regulatory purposes. The next section considers the changing perceptions of the objectives of financial reporting, followed by a summary and conclusion section. An addendum discusses how pooling accounting might enter into the debate as to the reasonableness of third-party reimbursement rates following combinations of health care organizations.

RATE MAKING INFORMATION NEEDS OF REGULATORY AUTHORITIES⁶

Rowe and Anderson [1993, p. 7] note that in the late nineteenth century, state legislatures across the United States imposed regulation over the then rapidly developing electric utility industry. State legislatures understood that a utility was a natural monopoly—i.e., because of economies of scale, the cost of service is lower with a single provider than with several utility companies competing with one another.⁷ Rowe and Anderson [1993, p. 7] refer to a “regulatory compact” that state legisla-

⁶Some public utilities are subject only to state regulation, others only to federal regulation, and still others to state and federal regulation. As a result, there have been numerous rate making decisions by state and federal regulatory authorities since the 1880's. Many of these decisions were subsequently argued before state or federal courts; and many decisions of regulatory authorities and lower level state and federal courts were supported or overturned by higher level courts and ultimately by the U.S. Supreme Court. An extensive literature summarizes these cases. See, e.g., Baur, 1944; Carpenter, 1950; Joslin and Miller, 1957; Hearth et al., 1988. This paper emphasizes the decisions of the Federal Energy Regulatory Commission (FERC), formerly the Federal Power Commission (FPC), and the U.S. Supreme Court.

⁷At least since the 1970s if not before, some of these natural monopoly positions were lessened due to changing technology and economics. For example, presently two or more electric utility companies may compete to provide electric power over the same transmission lines, and interstate trucking competes more effectively with railroads than heretofore. As a result, regulators and legislators saw a reduced need to protect the public from the potential abuse of the monopoly positions of utilities, and the extent of regulation has been reduced. For example, the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 reduced the extent of federal regulation of railroads.

tures established to impose responsibilities on both the utilities and the state:

Utilities were obliged to provide universal, adequate service and submit themselves to rate and service regulation so customers would be protected from the abuses of monopoly power (high prices and poor service). States agreed to afford companies an opportunity to earn a reasonable return on prudent investments. Regulation was imposed as a substitute for competition.

Federal regulation of natural monopolies started at about the same time. For example, the Interstate Commerce Act of 1887 established the Interstate Commerce Commission to regulate railroads. Other natural monopolies ultimately subject to state and/or federal regulation include natural gas, water, street cars, bus lines, trucking, and airlines.

Joslin and Miller [1957, p. 1035-1036] note that the basic theory of regulation focuses on setting utility rates at a level sufficient to give the utility a "reasonable" rate of return on its investment. If the rate is set too low, it is deemed to be "confiscatory," to involve a "taking of private property for public use without just compensation," and is a violation of the due process clause of the fourteenth amendment. Leventhal [1965, p. 995] adds that as a result of the 1944 Hope Natural Gas case,⁸ another concern of utility regulation is making sure that the rate of return is sufficient for a utility to accumulate and attract the capital needed for the maintenance and growth of productive assets to satisfy the public's demand for service.⁹ Bernstein [1937, p. 129] elaborates that rate making "...should also be sufficiently responsive to changing economic conditions to prevent an undesirable divergence of utility rates from the costs of producing utility services."

Rate setting involves fixing the selling price of the services provided by the utility, which directly affects the amount of revenues, and determining the allowable expenses to be deducted

⁸Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). See also 320 U.S. 591; 64 S. Ct. 281; 88 L. Ed. 333; 1944 U.S. Lexis 1204.

⁹Interestingly, Leventhal [1965, p. 995] notes that as a result of the Hope case, "... the leading cases suggest that the primary legal standard offered by the [U.S. Supreme] Court is the standard of comparable earnings. This standard, too, aims at attracting and holding capital, but it alone permits direct examination of the ratio between the earnings of a utility and its net worth in comparison with that ratio in companies of similar risk." However, the measurement of net worth remains controversial, with different regulatory authorities favoring aboriginal cost, prudent investment, and fair value. See also Sparrow, 1965, p. B329.

from revenues to derive the income or return. Rate making requires guidelines to measure the income or return, which is the numerator, and the investment or rate base, which is the denominator, and then ascertaining whether the resulting rate of return on investment is reasonable.¹⁰

According to Joslin and Miller [1957, p. 1048], public utilities traditionally argue that ownership of property includes the right to earn a return on it; that this return, since it is regulated by the state, has to be a “fair” return on the “fair value” of the property; and that unless a utility is afforded the opportunity to earn a fair rate of return on the fair value of the property, the property is being confiscated without due process, comparable to the state appropriating physical assets without payment of just compensation.

In *Smyth v. Ames* (1898), the U.S. Supreme Court prescribed use of fair value of utility property to measure the rate base.¹¹ Requiring use of fair value to measure the rate base was reaffirmed by the U.S. Supreme Court in several subsequent cases until the early 1940s. For example, in the 1923 *Southwestern Bell Telephone Company* case,¹² the U.S. Supreme Court reversed a state supreme court’s order and held that the rate base should reflect the [fair] value of the property at the time the rates were set, not the original cost, thereby reaffirming *Smyth v. Ames*; because the property had increased in value, the U.S. Supreme Court concluded that *Southwestern Bell* was entitled to rates that reflected the benefit of the increase.

Initially, the fair value of the property was estimated as the present value of the estimated fair return on the property. Joslin and Miller [1957, pp. 1048-1049, fn. 62] and others note the cir-

¹⁰This paper is concerned principally with showing how pooling accounting evolved as a way to facilitate the increasing use of aboriginal cost valuations of the rate base—i.e., the denominator of the rate of return calculation. Of course, the valuation of utility assets in the rate base at aboriginal cost rather than at fair value subsequently affects the measurement of depreciation expense and income (return)—i.e., the numerator—of the rate of return calculation. This paper emphasizes the measurement of the denominator—the rate base—not the income numerator.

¹¹*Smyth v. Ames*, 169 U.S. 466, 546-47, modified on rehearing, 171 U.S. 361 (1898), as cited by Joslin and Miller, 1957, p. 1030, fn. 11. “The basis of all calculations as to the reasonableness of rates ... must be the fair value of property being used by it [the utility] for the convenience of the public.”

¹²See *State of Missouri Ex Rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri, Et Al.*, No. 158., Supreme Court of the United States, 262 U.S. 276; 43 S. Ct. 544; 67 L. Ed. 981; 1923 U.S. Lexis 2642; 31 A.L.R. 807.

cularity inherent in arguing that a utility has the right to earn a fair rate of return on the fair value of its property measured this way, because the fair value of property reflects the earnings that can be obtained from its use. Utilities overcame this circularity by using estimated reproduction cost of existing property to approximate its fair value. However, Smith [1946, p. 295] notes that estimated reproduction cost of existing property is a poor measure of its fair value because most existing utility property would not be replaced with the same property due to technological improvements; rather, it would be replaced, usually at lower cost, with more efficient property. Additionally, the process of estimating reproduction cost was extremely expensive and time consuming, as was the process of arguing before regulatory authorities and courts as to the reasonableness of estimates of reproduction cost to measure the rate base.¹³

More important, in the Hope Natural Gas Case,¹⁴ the U.S. Supreme Court reversed a decision of the U.S. Court of Appeals and held that the Federal Power Commission (FPC) is permitted [but not required] to use historical cost to measure the rate base.¹⁵ However, Joslin and Miller [1957, p. 1048] note that "... rate base/rate of return is still the dominant concept in rate regulation.... Rate making is still, despite the end-result language in Hope, a 'fair return' on a rate base."

Therefore, the issue comes down to the valuation of utility property in the rate base. Traditionally, utilities seeking higher

¹³See Smith [1946, p. 295]. Smith [1946, p. 295] notes that "... probably 300 man-years were required by the company and the Wisconsin Commission to make a [reproduction cost] valuation of the Wisconsin Telephone Company. The Ohio Bell Telephone Company case was in process fourteen years, the New York Telephone case a like period of time, and the Illinois Bell Telephone case twelve years. He [1946, p. 295] describes this attempt to determine fair value by using reproduction cost of existing property as "... probably the greatest hoax ever perpetrated on the American consuming public." Earlier, Healy [1938, p. 6] criticized reproduction cost for similar reasons: "When one realizes the complexities and antipathies which reproduction appraisals have engendered in the field of rate regulation, one regrets its use in balance sheets. It is based on a misapplication of the doctrine of *Smyth v. Ames*. Its principal products will be confusion and deception."

¹⁴*Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). See also 320 U.S. 591; 64 S. Ct. 281; 88 L. Ed. 333; 1944 U.S. Lexis 1204. See also Joslin and Miller [1957, p. 1048].

¹⁵As a result of the Department of Energy Organization Act of 1977, various energy-related federal agencies were consolidated into a newly-formed Department of Energy (DOE). The FPC (FPC) was retained as a separate independent regulatory body within the DOE; however, it was renamed the Federal Energy Regulatory Commission (FERC).

rates favor valuation at fair value whenever it is higher than aboriginal cost, with fair value estimated as present value of estimated earnings, or as estimated reproduction cost of existing property. On the other hand, consumer advocates seeking lower rates traditionally favor valuation at aboriginal cost, which is usually lower than fair value.¹⁶

In addition, when reviewing a request to recover an investment in utility assets through inclusion in the rate base, regulators traditionally rely on two tests: (1) the *prudent investment test*, and (2) the *used and useful test*. According to Hearth et al. [1988, pp. 16-17], under the *prudent investment test*, if regulators conclude that a utility made an imprudent investment in utility assets based on then available information, some or all of that investment may not be recoverable by inclusion in the rate base.¹⁷ The *used and useful test* asks whether the investment will

¹⁶Brundage [1950, p. 388] notes a reversal of positions in the fair value versus aboriginal cost debate to measure the rate base: “[T]he relatively high initial cost of the transcontinental railroads and the decline in the general price level during the last quarter of the nineteenth century led the shippers [as consumers] and the regulatory commissions during that period to take the position that the railroads [and other utilities] were not entitled to a fair return on original cost but only on the then present [fair] value of the property....The Supreme Court in *Smyth v. Ames* upheld this view in 1898. Since the turn of the [twentieth] century, however, the price trend has been upward and the commissions, changing their position, have tried to hold the utilities down to actual cost. At the same time the railroads naturally switched their position and insisted on the higher replacement values [or fair] values. The Supreme Court continued to hold to its position in *Smyth v. Ames* [until 1944]” See also Horne [1942, p. 252].

¹⁷Hearth et al.[1988, p. 17] add that by satisfying the *prudent investment test*, a utility can usually recover some or all of the sunk costs of a canceled plant but not necessarily a return on that sunk cost. They [1988, p. 17] cite the *New England Power Company* case, which was upheld by the federal courts, where the Federal Energy Regulatory Commission (FERC) ruled that investors and ratepayers jointly share the risks and potential benefits from constructing new plants, hence should share in the costs of plant that is canceled before completion; however, the utility should not earn a return on that sunk cost, even if the utility acted prudently. See *New England Power Company v. Federal Energy Regulatory Commission*, 668 F. 2nd 1327 (1981).

On the other hand, in several states, utilities were denied any recovery of sunk costs of cancelled plants. For example, Hearth et al.[1988, p. 17] note that the Ohio Supreme Court overturned an Ohio Public Utilities Commission ruling that *Cleveland Electric Illuminating Company* was entitled to recover the sunk costs of three cancelled nuclear power plants. The Ohio commission reached its decision by applying both the *prudent investment test* and the *used and useful test*, and also argued that its decision was consistent with the vast majority of decisions in other jurisdictions. However, the Ohio Supreme Court rejected this reasoning and held that, under Ohio law, all sunk costs of canceled investment were extraordinary losses and not recoverable. Hearth et al.[1988, p. 17] note that the Ohio Supreme

be used by the rate paying public, and will it be useful to them. If used and useful, the utility is allowed to recover its investment; if not used and useful, the utility is not allowed to recover that investment.¹⁸

Notwithstanding prudence in the decision to invest, Priest [1966, p. 307, italics added] notes that “[l]oss of value arising out of deflation, or obsolescence, or changed economic conditions, will inevitably be recognized for the purpose of making utility rates.” For example, in the Market Street Railway case,¹⁹ the U.S. Supreme Court reaffirmed the decision of the California Railroad Commission to set the rate base of a San Francisco street railway company at \$7,950,000--the price that company offered the property for sale to the city--although its book value was \$41,768,505 and its estimated reproduction cost was \$25,000,000, and noted the following:

... it may be safely generalized that the due process clause never has been held by this Court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it

Court reaffirmed its decision in three subsequent cases. See also *Market Street Railway Co. v. Railroad Commission of California ET AL.* Nos. 510, 511, Supreme Court of the United States, 324 U.S. 548; 65 S. Ct. 770; 89 L. Ed. 1171; 1945 U.S. LEXIS 2625, February 26, 1945, Argued, March 26, 1945, Decided.

¹⁸Utility plant may satisfy the *used and useful test* without being currently in use, sometimes without ever being in use. For example, Priest [1966, p. 310] notes that a vintage electric generating plant that is less efficient than modern plants will be included in the rate base if it is being maintained in condition as a standby reserve and is being used from time to time. Such a plant will not be included in the rate base, however, if it is not being properly maintained and has not produced electricity over a lengthy period.

In other situations, utility plant may satisfy the *used and useful test* without ever being in use. For example, Hearth et al.[1988, p. 17] note that many regulatory bodies have used the used and useful test in allowing utilities to recover the sunk costs of cancelled nuclear generating plants that, by definition, is never used by the rate paying public. But they [1988, p. 17] also note that in applying the *prudent investment* and *used and useful tests*, regulators usually examine three decisions: (1) to begin construction; (2) to incur costs during construction; and (3) to cancel the plant. According to Hearth et al.[1988, p. 17], regulators occasionally conclude that utilities waited too long before canceling plants and prohibit recovery of sunk costs incurred beyond some earlier date.

¹⁹*Market Street Railway Co. v. Railroad Commission of California ET AL.* Nos. 510, 511, Supreme Court of the United States, 324 U.S. 548; 65 S. Ct. 770; 89 L. Ed. 1171; 1945 U.S. LEXIS 2625, February 26, 1945, Argued, March 26, 1945, Decided.

has vanished, *even if once prudently made*, or to maintain the credit of a concern whose securities already are impaired. *The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.*

Accordingly, under the *prudent investment test* and the *used and useful test*, investment might be measured at some estimate of fair value, aboriginal cost, or some adjusted historical cost.

RATIONALE OF ABORIGINAL COST FOR REGULATORY PURPOSES

Stickney et al. [2010, p. 835] define aboriginal cost in public utility accounting as "... the acquisition cost of an asset incurred by the first entity devoting that asset to public use." They [2010, p. 835] note that "[i]f regulators used a different cost basis, public utilities could exchange assets among themselves at ever-increasing prices in order to raise the rate base," which would be followed by raising the regulated prices based on that rate base.²⁰

Closely related to the concept of aboriginal cost and the prudent investment test is using *prudent investment* theory to measure the rate base. As expounded in his famous dissent in the 1923 Southwestern Bell case, U.S. Supreme Court Justice Louis Brandeis argued that what the investor devotes to the public use (and for which s/he is entitled to a fair return thereon) is not specific property, whose value fluctuates due to changing prices but diminishes due to depreciation; rather, Justice Brandeis favored using the objectively ascertainable amount of invested capital to measure the rate base, usually measured at aboriginal cost [see also Carpenter, 1950, pp. 374-75; and Urotsky, 2009, pp. 611-614]. According to Brandeis' prudent investment theory, the investor is entitled to receive a return on the amount of capital *prudently invested* in the utility enterprise, and no more. Such a rate base would be definite, permanent, and high enough to yield the investor an adequate return, without allowing the investor to reap profits on money s/he never invested. However, as Carpenter [1950, p. 375] notes, despite the

²⁰Bonbright [1945, p. 444] notes that "... despite all attempts to ridicule an original-cost rate base by calling it 'aboriginal cost,' or other funny names, such a rate base is required as a general rule by the logic of the prudent investment principle."

cogency of Brandeis' arguments, the U.S. Supreme Court did not sanction use of aboriginal cost or the prudent investment theory to measure the rate base until the 1944 Hope Natural Gas case.²¹

Bonbright [1945, p. 442] distinguishes the fair value standard from the concept of aboriginal cost under the prudent investment theory as follows:

The "fair value" standard undertakes to make the rate base depend on the value of the utility property at the time when the rates are being fixed, however much this value may deviate either from original construction cost or from actual cost to the present owner. The "prudent investment" standard, on the other hand, uses as its criterion not the value but rather the cost of the property devoted to the public service so long as this cost may be deemed to have been prudently incurred.

For public utility rate making purposes, the prudent investment theory implies that a fair return is allowed only on prudent investments in utility property. As Bonbright notes [1945, pp. 442-443, italics added], "[o]rdinarily, the relevant cost is the cost of constructing the properties used and useful in the public service, and this cost, save in a somewhat unusual case, means the same thing as the *cost of the property when first devoted to the public service* so long as this cost may be deemed to have been prudently incurred."

However, public utilities argue that whenever utility property has been transferred to another company at a price in

²¹ There have been many different ways of applying the prudent investment theory. For example, Carpenter [1950, pp. 389-394] notes that during its first seven years, the Pennsylvania Public Service Commission adopted the following different forms of prudent investment: (1) undepreciated original cost; (2) depreciated original cost; (3) book cost less book reserve; and (4) invested capital.

Baur [1944, pp. 506-507] argues that prudent investment should be defined as original cost less accumulated depreciation due to physical wear and decay and to various functional causes such as obsolescence. He criticizes prudent investment as original cost without deducting depreciation, as follows: "[O]nce a corporate investment is made, it must subsequently be fully maintained or it will be impaired or dissipated. Such full maintenance consists of ordinary repairs plus proper provisions for depreciation as it accrues, both charged regularly to operating expenses, which are in turn included in rates paid by consumers. If the total original cost of plant were included in the rate base [without deducting accumulated depreciation], the company would get a return not only on its own actual or unimpaired investment, but also on the amount of consumer contribution provided in the rates for the purpose of conserving the corporate investment [i.e., for the purpose of recovering a portion of the original cost equal to accumulated depreciation]."

excess of its original cost, this higher resale price is the new cost that should be substituted for the original cost as the measure of the rate base; utilities argue that the rate base should reflect this new cost of the property to the present owner, not the original owner. The fallacy of this argument, according to Bonbright [1945, p. 443], is that consumers of public utility service would be compensating investors not only for building plants devoted to public service but also for buying plants from other persons who have already built them and who have already been compensated for devoting them to public service:

Once these utility properties have been built and have been put into public service, investors who buy them later from their original owners are simply taking over these former owners' claims to a return on the capital devoted to the public service. We have here essentially the same situation that applies when an investor buys in the open market some shares of stock in a public utility company. Such an investor may have bought this stock at a very low price ... or at a very high price.... In either case, moreover, the price that he paid may have been a rational or reasonable price in the light of then current expectations of earnings and dividends. Yet, this investor could hardly adduce the high price that he may have paid for his stock as an argument for public utility rates designed to make the stock worth what he paid for it. On the other hand, a group of consumers would hardly be allowed to establish the low price which a stockholder paid for his stock in support of a low rate base.

Bonbright [1945, pp. 445-46] notes that a step up of the rate base of productive assets for rate making purposes may be justified incident to combinations brought about by cash purchases:

In an ordinary cash purchase of a utility property from former owners who have been able to exact a price in excess of original cost, the new owner can make the plausible argument that, unless he is granted a rate base higher than that which would be accorded to the very same property in the hands of the former owners, his purchase would impose upon him a financial loss, and this is a potent argument for recognition of the excess acquisition adjustment cost [in the rate base] wherever the purchase of the old property by the new owner at a price in excess of what would be the old

owner's rate base was required in the public interest.²²

However, Bonbright [1945, p. 446] argues that no step up above aboriginal cost of productive assets for rate making purposes is justified for combinations brought about by exchanges of shares.

... if the old owners of the properties, instead of selling out, have merely pooled their separate interests [in a stock-for-stock business combination], thus retaining as a group the same assets that they had before the consolidation, they are hardly in a position to urge that they must receive an enhanced rate base because of the price that they have been compelled to pay themselves in order to induce themselves to consent to the merger. Indeed, ... it would seem probable that the transactions were of great benefit to the security holders even without reference to any claim for an enhanced rate base.

Bonbright [1945, pp. 445-446] elaborates that combinations brought about by exchanges of stock rather than by cash purchases "... lacked the characteristic of an ordinary purchase and sale whereby a new owner takes over the properties while the old owner takes his cash and gets out." To Bonbright [1945, p. 445, italics added], such combinations "... are mere *pooling of interests*, in which each old stockholder surrenders his stock in his separate company in exchange for stock in the enlarged new company."

Interestingly, perhaps the most prominent advocate of aboriginal cost of productive assets for rate making purposes was Franklin Delano Roosevelt, first as Governor of New York State between 1929 and 1933, then as President of the United States between 1933 and 1945. According to Tobey [1997, p. 61], Roo-

²²According to Bonbright [1945, p. 444], this is an exception where prudent investment theory uses a valuation in excess of aboriginal cost for measuring the rate base: "This exception applies to situations where a utility property has been acquired by new owners as a necessary step in improving the public service, by making a better, more efficient unit through the combination of existing utility properties. In such a case, if the new owner was compelled to pay more than original cost in order to accomplish this socially desirable objective, and if the public benefit resulting from the acquisition of the property is more than enough to offset the public burden of the higher rate base, the inclusion in the rate base of the necessary purchase price seems to me to be in harmony with the 'prudent investment' principle."

On the other hand, Priest [1966, p. 319] notes that "... when utility property is acquired at less than its original cost, the rate base is measured by the purchaser price: "The theory is that it would not be 'fair' to impose an original-cost rate base on consumers in such circumstances."

sevelt sought to further social modernization and enhance the quality of life and living standards of the masses by reducing the cost of residential electricity and thereby encouraging its more widespread use by homeowners. At a time when perhaps only 20 percent of private homes in the United States were electrified and electric rates were substantially higher for homeowners than for industry, Roosevelt reasoned that the more widespread use of electricity in the home would further social modernization, reduce poverty, and lessen the drudgery of housekeeping. In Roosevelt's words,

[w]e all know that the great magic of electricity was originally used for lighting purposes only. It then spread to the factory for industrial uses. Now, however, the time has come when electricity should be carried right into our very homes so as to lighten the drudgery of housekeeping. You and I know that scores of electrically operated household appliances have been invented. Of course, the housewives of the State cannot enjoy these new inventions as long as the rates for [electric] current continue to run as high as they now do.²³

Tobey [1997, p. 95] notes that to Roosevelt, "[p]rogressive social modernization meant more than the material improvement of lives. It meant also the moral improvement of life, as a matter of social justice, through technology." He [Tobey, 1997, pp. 59-60] also notes that Roosevelt favored using aboriginal cost [although he used the term *cash cost* rather than *aboriginal cost*] as a means of reducing the rate base and with it the rates utilities charge residential consumers. As Tobey [1997, pp. 59-60] notes,

Court cases established that the utilities could use "replacement cost" as the basis for determining fair profits and rates. This rule permitted the utilities to bloat their capitalization, because the costs of electric plants in the future would be higher (if only because of general inflation). Roosevelt in turn pushed for statutory determination of "cash cost" [i.e., aboriginal cost] as the basis for determining profit and rates. Profit ought to be determined on the basis of the actual cash capitalization made by the companies in building their electrical plants and distribution system. This, after all, was the real debt being paid. Court permission to base profit on

²³ Gubernatorial campaign address, Syracuse, New York, October 22, 1930, p. 20, as quoted by Tobey, 1997, p. 61, fn. 43.

future replacement costs meant that companies could calculate profit on fictitious sums they had not really spent. Rates were correspondingly higher.

Thus, using aboriginal cost for measuring the rate base was viewed by economic policy makers such as Roosevelt as a means of fostering the social and economic policies of enhancing living standards by reducing utility rates.

RATIONALE OF POOLING ACCOUNTING FOR REGULATORY PURPOSES

Wyatt [1963, p. 22] notes that the term *pooling of interests* was used initially to describe *transactions* involving combinations of closely related utility companies that sought to include its assets in the rate base at fair value as of the combination date. He [1963, p. 22] also notes that the FPC held that valuation at fair value was improper and that no new values should attach to the properties since such combinations did not involve a change in substance. For example, in the 1943 Montana Power Company case,²⁴ the FPC ruled that this combination of related companies “.. was not a sale by which one party disposed of an interest and another acquired that interest. Just as clearly actual legitimate cost cannot be increased by a transaction which does not result in parting with property.”

Shortly thereafter, according to Wyatt [1963, p. 22], the term *pooling of interests* was used to describe combinations of previously *unrelated* interests that were fused into one company to be owned jointly—i.e., stock-for-stock combinations. In the 1943 Niagara Falls Power case involving such a combination, the U.S. Supreme Court affirmed the FPC order that the utility should reduce the valuation of its properties to actual legitimate costs (except for certain land); the court found that the utility was not entitled to have its properties measured at fair value for rate making purposes.²⁵

Although the term *pooling of interests* was used initially to

²⁴In the matter of the Montana Power Company, United States Power Commission. Opinions and Decisions of the FPC, vol. 4, Oct. 1, 1943-Dec. 31, 1945, p. 235, cited by Wyatt, 1963, p. 23.

²⁵Niagara Falls Power Co. v. FPC, 320 U.S. 792; 64 S. Ct. 206; 88 L. Ed. 477; 1943 U.S. LEXIS 113 @ <http://www.lexisnexis.com.remote.baruch.cuny.edu/hottopics/lnacademic/?verb=sf&sf=AC00NBGenSrch>. However, it is the 1944 Natural Gas Hope case that is most often cited as the precedent where the U.S. Supreme Court explicitly empowered the FPC and other regulatory authorities to use aboriginal cost to measure the rate base. See *supra*, p. 8.

describe a stock-for-stock combination transaction, not the accounting treatment of that transaction, Wyatt [1963, p. 23] notes that the accounting treatment "... flowed from the manner in which the Federal Power Commission viewed the transaction...." The FPC favored aboriginal cost to measure the rate base--i.e., carrying forward the book values of utility assets of the constituent companies of stock-for-stock business combinations. Clearly, carrying forward book values of productive assets under pooling of interests accounting is consistent with the concept of aboriginal cost that was being used for rate making purposes. The practice of using the same term *pooling of interests* to describe the financial reporting for such stock-for-stock combinations developed later.

American Institute of [Certified Public] Accountants Input: In 1945, the AI[CP]A's Committee on Public Utility Accounting [CPUA, 1945, p. 152] reported to the AI[CP]A Council that the FPC has been suggesting the following three propositions in rate cases:

- (1) No new cost can be created by a reorganization that does not result in a material change of individual stock ownership.
- (2) No new cost can result from a transaction that (a) is at less than arm's length or (b) may be regarded as effecting a pooling of interest.
- (3) Where a change in stock ownership takes place without any change in corporate entity, a new cost can be determined for all the property of the corporation on the basis of the aggregate of the sums paid by the new stockholders for their holdings; and, further, that the cost of individual pieces of property may be determined by allocation of the cost arrived at for the aggregate of all the property.

The CPUA noted that the Commission's propositions apparently conflict with the then current accounting standards of *Accounting Research Bulletin No. 24*, "Accounting for Intangible Assets" [ARB 24, 1944]. Under ARB 24 [1944, para. 1], stock-for-stock combinations were reported at cost consistent with purchase accounting, with cost "...determined either by the fair value of the consideration given or the fair value of the consideration received, whichever was more clearly evident." Additionally, under ARB 24 [1944, para. 5], the excess of cost over book value was allocated to the tangible assets and preferably also to intangible net identifiable assets of the acquiree whenever prac-

licable to do so, with any residual excess recognized as goodwill.²⁶ Such an allocation of fair value results in reporting the tangible and intangible assets of the acquiree at acquisition date fair value for 100% acquisitions; and partly at fair value and partly at book value for less-than-100% acquisitions, consistent with the then prevailing parent company theory of consolidated financial statements.²⁷ However, the CPUA [1945, p. 151] noted that it had not carefully studied the FPC's propositions and would not express an opinion on them.

The AI[CP]A's Committee on Accounting Procedure (CAP)—the official U.S. accounting standard setter from 1939 to 1959—took up the report of the CPUA. It *initially* concluded [CAP, 1946, pp. 441-442, italics added] that a pooling of interests, which it defined as a combination of two or more interests of comparable size, "... may represent another situation in which a *new basis of accountability* is properly recognized and in which assets are most significantly reflected in the accounting records at monetary values most nearly representative of their *fair value* at that time."²⁸ Presumably, this initial conclusion was favored by utility companies that were pushing for higher fair value valuations all along.

However, Wyatt [1963, p. 24] notes that this initial conclusion of the CAP—i.e., that fair values incident to a new basis of

²⁶Under ARB 24 [1944, para. 3], limited life intangible assets were amortized against earnings, as was limited life goodwill; indefinite life intangible assets and goodwill was not amortized but, if impaired, were written down against earned surplus (retained earnings), not capital surplus (additional paid-in capital). ARB 24 [1944, para. 6] discouraged but did not prohibit the prior practice of immediate write off of goodwill against either capital surplus or earned surplus.

²⁷Under the parent company theory, subsidiary identifiable net assets are reported at acquisition at book value adjusted for the parent company's share of the excess of fair value over book value. The parent company theory was prevailing U.S. GAAP and IFRS until superseded by the economic unit theory by FASB Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements" [SFAS 160, 2007], in ASC Section 810, and by International Financial Accounting Standard No. 22, "Noncontrolling Interests in Consolidated Financial Statements" [IFRS 22, 2007]. Under the economic unit theory, subsidiary identifiable net assets are reported at acquisition at fair value.

²⁸Interestingly, the CAP [1945, p. 441] initially seemed to call for fresh start accounting for stock for stock combinations of companies of comparable size, whereby all the assets and liabilities of both companies are reported at fair value. In an AICPA-sponsored research study that was intended to underlie a new pronouncement on accounting for business combinations by the APB, Wyatt [1963, p. 82] also called for fresh start accounting for combinations of companies of comparable size, which Wyatt called *fair value pooling*. However, the APB never endorsed fresh start accounting, and the FASB (and the IASB) explicitly reject fresh start accounting.

accountability may be recognized incident to a stock-for-stock pooling of interests combination of companies of comparable size--was never officially adopted in its (or its successor APB's) pronouncements on generally accepted accounting principles. Quite the contrary resulted. Starting with *Accounting Research Bulletin No. 40*, "Business Combinations" [ARB 40, 1950, para. 5], the CAP called for pooling of interests combinations to be accounted for by carrying forward historical cost book values of net assets of the constituents, not by reporting any net assets at fair value. The CAP continued to prescribe this carrying forward of book values for pooling of interests combinations in *Accounting Research Bulletin No. 43*, "Restatement and Revision of Accounting Research Bulletins" [ARB-43, 1953, ch. 7, sect. c, para. 5], and in *Accounting Research Bulletin No. 48*, "Business Combinations" [ARB 48, 1957, para. 9]. Essentially the same accounting for pooling of interests combinations was also prescribed by the APB in *Opinion No. 16*, "Business Combinations" [APB 16, 1970, paras. 50-51]; additionally, APB 16 [1970, para. 12 et passim] describes this carryforward of basis accounting for the first time in the authoritative U.S. GAAP literature as the *pooling of interests method*.²⁹

Securities and Exchange Commission Input: At about the same time, the U.S. Securities and Exchange Commission (SEC) became a strong supporter of pooling accounting [see, e.g., Seligman, 1982, pp. 424-428]. Indeed, on occasion, the SEC sometimes mandated pooling accounting for stock-for-stock combinations that otherwise might have been subject to purchase accounting under then existing GAAP [see Barr, 1958, pp. 12-13]. The SEC's strong support for pooling accounting emanated from its aversion to most upward revaluations of plant assets and higher depreciation charges based on such upward revaluations, especially for rate making purposes.

Zeff [2007, p. 49] elaborates that "[f]rom its founding in 1934 until the early 1970s, the SEC and especially its Chief Accountant disapproved of most upward revaluations in property,

²⁹The various tests to qualify for pooling accounting changed as ARB 43 superseded ARB 40, as ARB 48 superseded ARB 43, and as APB 16 superseded ARB 48. In general, each pronouncement refined the tests but was followed by a relaxation of the new tests in practice. See Sapienza, 1962, pp. 268-78; Seligman, 1982, pp. 424-428; and Rayburn and Powers, 1991, pp. 160-188. Additionally, more and more combinations were structured as exchanges of stock for stock to qualify for pooling accounting notwithstanding premiums paid (in shares) to so qualify. See Ayers et al., 2002, 6-7; and Lys and Vincent, 1995. Space limitations preclude further consideration of these issues.

plant and equipment as well as depreciation charges based on such revaluations." Zeff [2007, p. 50] credits Robert E. Healy, one of the five founding SEC commissioners, as the person who effectively cemented the SEC's aversion to upward revaluations of plant assets:

Healy was livid at the asset value write-ups that public utilities had been booking.... He complained of 'write-ups used to create income or to relieve the income accounts of important charges,' which would be debited to the revaluation reserve account that had been credited with the write-ups.... He was driven to the conclusion that all upward departures from historical cost were veritably heinous.

Healy also emphasized the importance of the stewardship function of accounting. His views on the objectives of accounting are aptly captured in his own words [Healy, 1938, p. 6]:

[T]he purpose of accounting is to account--not to present opinions of value.... The value of a corporation's property may be much or little--or uncertain. Its cost is usually certain. The capital entrusted to the management can usually be ascertained. What has been done with that capital can be ascertained through accounting. The steward must account for the talents entrusted to him. Accounting to me means the making of a historical record of financial events. Valuation is a very different matter.

In other words, Healy opposed utility plant asset revaluations [and was a strong advocated historical cost] at a time when the SEC viewed the objectives of general purpose financial statements to include stewardship and decision usefulness for several user groups, including rate making by utility regulators--not just investment decisions by stockholders and creditors.

As Zeff [2007, p. 50] notes, given Healy's influence over the first four SEC's chief accountants, his opposition to plant asset revaluations and his advocacy of stewardship and historical cost valuations led inevitably to SEC support for pooling accounting. This position is consistent with the concept of aboriginal cost and the stewardship objective of financial reporting.

Accordingly, pooling accounting evolved as the FPC (and other regulatory authorities) started to use aboriginal cost and prudent investment theory in determining utility rate bases once they were permitted to do so as a result of U.S. Supreme Court decisions in the early 1940s. In the usual situation of rising price

levels, adherence to aboriginal cost under pooling accounting resulted in reporting acquiree productive assets and measuring utility rate bases at lower aboriginal cost book values rather than at higher fair values. *Ceteris paribus*, lower rate bases resulted in lower utility rates. In turn, lower rates encouraged more widespread use of electricity, thereby reducing the drudgery of housework and enhancing living standards and economic growth consistent with social and economic objectives of public policy makers.

Of course, pooling accounting also became increasingly popular by corporate management of unregulated companies because it did not involve write ups of carrying values of inventories and limited life tangible and intangible assets that would result in reporting higher expenses and lower earnings subsequent to the combination date. Although pooling accounting provided useful information for rate making decisions by utility regulators and facilitated certain economic and social policies, it was criticized for providing less useful if not misleading information for investment decisions by stockholders and creditors because it understated post-combination operating expenses and overstated post-combination earnings.

Subsequently, most of the accounting literature on pooling accounting addressed issues applicable to unregulated companies, not regulated ones; and much of the criticism of pooling accounting dealt with its perceived defect of reporting productive assets at historical cost book values rather than at fair values for decision making by stockholders and creditors. Little attention was given to other objectives of financial reporting, including the benefits of reporting productive assets at historical cost book values for rate making and stewardship purposes and to facilitate social and economic policies. The next section of this paper discusses the changing perceptions of the objectives of financial reporting.

CHANGING PERCEPTIONS OF OBJECTIVES OF FINANCIAL REPORTING

Presently, *decision usefulness* to stockholders and creditors is viewed explicitly by accounting standard setters as the basic objective of financial reporting; and *neutrality* is viewed as a desirable quality and an essential component of *faithful representation* of accounting information. However, such was not the case when pooling accounting was developed in the 1940s. Perceptions about the objectives of financial reporting have changed

over the years, as have what constitute desirable qualities of useful accounting information.

Present Perceptions of Objectives: In developing financial accounting standards, including SFAS 141 (2001) which prohibited pooling accounting, the Financial Accounting Standards Board (FASB) relied in part on its conceptual framework. In *Statement of Financial Accounting Concepts No. 1*, “Objectives of Financial Reporting by Business Enterprises” [SFAC-1, 1978, paras. 34, 37]), the FASB concludes that the basic objective of general purpose external financial reporting is to provide information that is useful for investment decisions by stockholders and creditors. The FASB largely reconfirmed this basic objective in its *Statement of Financial Accounting Concepts No. 8*, “Conceptual Framework for Financial Reporting: Chapter 1, The Objective of Financial Reporting” [SFAC-8, 2010a, para. OB2], jointly developed with the International Accounting Standards Board (IASB).³⁰

In SFAC-1 [1978, paras. 25-26], the FASB reasons that other potential users of general purpose external financial reporting information—such as suppliers, employees, customers, tax and regulators, legislators, labor unions, trade associations, business researchers, teachers and students—either have similar information needs as investors and creditors and/or have the power to obtain whatever information they need. The FASB [1978, para. 26] notes, for example, that although tax and regulatory authorities often use information in general purpose financial statements, both have statutory authority to require the specific information they need to fulfill their functions and do not need to rely on general purpose external financial reporting information. Similarly, when a financial institution negotiates with an enterprise for a large loan or private placement of securities, it can often obtain the desired information by making that information a condition for completing the transaction. On the other hand, individual stockholders and creditors cannot require specific information if not provided in general purpose financial statements. SFAC-8 [2010a, para. OB5] reasons simi-

³⁰The emphases and conclusions of SFAC-1 differ somewhat from those of SFAC-8, and the FASB relied on SFAC-1, not SFAC-8, when it developed SFAS 141 (2001). Additionally, SFAC-8 is more succinct than SFAC-1 in addressing the information needs of regulators, public policy makers, and other users. For example, SFAC-8 discusses the information needs of regulators for maintaining financial stability, not for utility rate making. A word search of SFAC-8 failed to find a single reference to utility, utilities, regulated, or rate making.

larly that “[m]any existing and potential investors, lenders, and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports” As a result, SFAC-8 [2010a, para. OB5] follows SFAC-1 and concludes that potential investors, lenders, and other creditors “... are the primary users to whom general purpose financial reports are directed.”³¹

Importantly, SFAC-1 (as reconfirmed by SFAC-8) was the culmination of the FASB’s extensive deliberations in the 1970s, when individual and institutional stockholders and creditors (and their advisors) were becoming increasingly prominent if not the dominant user group among FASB constituents.³² Pooling accounting evolved long before the FASB developed its conceptual framework.

It is true that regulators may have the statutory authority to require specific information they need to fulfill their functions and do not need to rely on external financial reporting information. However, regulators often choose not to exercise such authority, and to rely on information in general purpose financial statements instead. For example, Quint [1994, p. 27] notes that utility regulators often insist on making decisions based on information in general purpose financial statements.³³ Similarly, in

³¹The FASB [SFAC-8, 2010a, para. BC1.23] also reasons that expanding the objective of financial reporting to provide information to regulators would deprive investors and creditors of information that they need; the only way to avoid conflicts would be to eliminate or deemphasize the objective of providing information to investors and creditors. It [SFAC-8, 2010a, para. BC1.23] concludes that “... eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets.”

³²The predecessor to the FASB, the APB, which functioned between 1959 and 1973, briefly specified a similar decision usefulness objective of financial accounting, again primarily for stockholders and creditors, but it also noted a stewardship objective of financial accounting. In *Concepts Statement No. 4*, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,” the APB [1970, para. 73, italics added] notes that the basic purpose of financial accounting and financial statements “... is to provide quantitative information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions. This purpose includes providing information that can be used in evaluating management’s effectiveness in fulfilling its stewardship and other managerial responsibilities.” See also Most, 1977, pp. 107-120. The predecessor to the APB, the CAP, which functioned between 1939 and 1959 when pooling accounting was developed, did not explicitly address the basic objectives of financial accounting in a comparable manner.

³³Quint [1994, p. 27] notes that in the Entergy Services case, the FERC permitted purchase accounting for regulatory purposes notwithstanding its preference for pooling accounting in order to avoid “... the undesirable effects that may result from potentially having different financial statements presented for regula-

assessing the adequacy of bank regulatory capital, U.S. federal regulatory authorities insist on using the same mark-to-market fair value accounting rules for loan portfolios that are used in general purpose financial statements under current U.S. GAAP.³⁴ Accordingly, it is somewhat simplistic (if not disingenuous) for the FASB and IASB to dismiss the needs of regulators for financial statement information.

Changing Perceptions of Objectives: Hendriksen [1970, p. 2] notes that the objectives of financial reporting have changed over time as one or more user groups have dominant influence over financial accounting standard setters. He [1970, pp. 102-103] notes that for many years [including the years in which pooling accounting was developed], another approach to standard setting was to assume that the basic objective of general purpose financial reporting is to provide information for a set of unknown users with multiple needs. At least before the FASB issued SCAC-1 in 1978 if not now, many accountants and financial report users concurred that the basic objective of financial accounting is broader in scope than as enumerated in SFAC-1 and reconfirmed in SFAC-8—i.e., to serve multiple users, not just stockholders and creditors.

tory and general financial purposes.” See also 64 FERC 61, 001, Federal Energy Regulatory Commission, before Commissioners: Elizabeth Anne Moler, Chair; Vicky A. Bailey, and Donald F. Santa, Jr., Entergy Services, Inc. v. and Gulf States Utilities Company, Docket Nos. EC92-21-001, EC92-21-002, ER92-806-001 and ER92-806-002, Issued July 1, 1993.

³⁴According to Berleau [2008, p. A15], the FASB’s mark-to-market fair value accounting rules are exacerbating the 2007 financial crisis: “Markets for individual loans are still much thinner than for stocks and bonds. The market for securitized loans with unique features is even thinner, and a disruptive event can cause these markets to virtually disappear. As a result, if a highly leveraged bank sells a mortgage-backed security at a steep discount, this becomes the ‘market price.’” Berleau [2008, p. A15] continues that “[a] single bank’s fire sale can decrease the [total] ‘regulatory capital’ [of the banking industry under U.S. GAAP, whereup] “... banks are forced to sell billions of dollars of assets to “clean up their balance sheets ... creating a “downward spiral of prices, marking down -- selling -- marking down again.” Representatives of the banking industry argue that the FASB’s mark-to-market fair value accounting rules result in unrealistic writedowns on loans that banks intend to hold to maturity, and should be replaced by other valuation rules, as least for measuring regulatory capital. See also Gorton, 2008, pp. 64-65; and Pinedo and Beck, 2008, pp. 6-8. However, federal regulatory authorities presumably maintain that using different methods is not politically expedient. Given the 2007 financial crisis and the subsequent call for transparency in financial reporting by banks, regulators presumably cannot mandate smaller loan loss provisions for regulatory purposes than for GAAP purposes; and the FASB claims that only the GAAP provisions are representationally faithful.

For example, in a 1961 AICPA-sponsored research study that was intended originally to underlie the development of accounting standards by the then newly established APB, University of California—Berkeley professor and AICPA Director of Accounting Research Maurice Moonitz [1961, pp. 23-27, italics added] argued that the basic objective of financial reporting is decision usefulness for many different user groups, not just for stockholders and creditors. Moonitz [1961, pp. 4-5, italics added] notes that

... anyone who stresses “usefulness” as a criterion, in accounting or elsewhere, must answer the two pointed questions--useful to whom? and for what purpose? And herein lies the danger. We could easily be trapped into defining accounting and formulating its postulates, principles, and rules in terms of some special interest, such as the business community, or the regulatory agencies, or investors, or tax collectors. But accounting has been used in the affairs of private business, regulated and unregulated, of profit motivated enterprises as well as nonprofit ones, of illegal as well as legal enterprises, of socially undesirable as well as desirable entities, of organizations in socialist, fascist, or communist states as well as those in free enterprise societies. *We cannot proceed on the premise that accounting is the monopoly of any one group*, whether that group is concerned mainly with the development of the accounting process or with its end-product in the form of financial statements and reports.

Thus, Moonitz [1961] defined the objectives of general purpose financial reporting more broadly than SFAC-1 [1978] and SFAC-8 [2010a] to provide information needed not only for investment and credit decisions by stockholders and creditors, but for other purposes and other users, including rate making by public utility regulators and fostering social and economic policies by public policy makers.³⁵

³⁵To some extent, of course, rate making by regulatory authorities and fostering social and economic policies are interrelated. For example, in setting rates, Leventhal [1965, p. 1017] notes that some utility regulators consider the quality of the utility service, which “... should include an awareness of the needs of the public as they change and grow, conscientious effort to put technological research and developments to the service of the community, and responsiveness to the community’s plans and programs.” Additionally, Breyer and MacAvoy [1973, pp. 949-950] note that regulating utility rates might be motivated not only to curb monopoly power but to redistribute income from producers to consumers. Interestingly, Breyer has been an associate justice on the U.S. Supreme Court since 1994.

When Moonitz was developing his ideas in the 1940s, 1950s and early 1960s, many practicing and academic accountants concurred with this broader view of the objective of general purpose financial reporting including, no doubt, some of the members of the CAP under which pooling accounting evolved into GAAP, as well as some members of the APB, and perhaps even some of the early members of the FASB;³⁶ many may still do. Importantly, pooling accounting developed in part to satisfy the information needs of utility regulators for rate making purposes and public policy makers for fostering social and economic policies in an era when many accountants, report users, and standard setters viewed the basic objective of general purpose financial reporting to include providing information for a set of unknown users with multiple needs.

Stewardship as Another Objective: Additionally, prior to SFAC-1 [1978] if not now, many Anglo-American accountants (and perhaps even more non-Anglo-American accountants) viewed *stewardship* (or *accountability*) as well as *decision usefulness* as important objectives of general purpose financial reporting. For example, Oldroyd and Miller [2011, p. 11] note that besides providing information that is useful for investment decisions by stockholders and creditors, a basic objective of accounting is to facilitate trade and investment by attesting to property rights and obligations, so that property owners have evidence to enforce their rights in courts of law:

Stewardship fits into the equation through the ability of accounts to communicate events at a distance.... In the modern era, the separation of ownership from management is not the main reason for the creation of agency relationships and accounts; rather, it is the need of shareholders to evaluate operations at a distance.... Decision usefulness, for its part, has existed as an adjunct to stewardship accounting for most of its history.

SFAC-1 [1978, para. 50] notes that “[f]inancial reporting should provide information about how management of an enter-

On the other hand, some commentators criticized regulatory authorities for using accounting requirements to foster social and economic goals. For example, Brundage [1950, p. 388, italics added] notes that “... one of the most serious complaints of the accounting profession—that the regulatory commissions, on occasion, have *used accounting requirements as a means for accomplishing social objectives*, although in so doing they may have departed from what was considered the best accounting practice at the time.”

³⁶ See, e.g., Paton and Littleton, 1940, pp. 2-3; and May, 1943, pp. 254-65.

prise has discharged its stewardship responsibility to owners for the use of enterprise resources entrusted to it.” It [1978, para. 50] notes that enterprise management

... is periodically accountable to the owners not only for the custody and safekeeping of enterprise resources but also for their efficient and profitable use and for protecting them to the extent possible from unfavorable economic impacts of factors in the economy such as inflation or deflation and technological and social changes.

SFAS-1 goes on to note that a central question for report users is how an enterprise and its owners are faring, and that the stewardship function of financial reporting helps answer this question. In SFAC 1 [1978], however, the FASB downplays *stewardship* relative to *decision usefulness* as a basic objective of general purpose financial statements.³⁷

SFAC-8 [2010, para. B1.27] notes more succinctly that because decision usefulness is the basic objective of financial reporting, there is no need for the conceptual framework to have separate sections on decision usefulness for credit and investment decisions versus decision usefulness for assessing management stewardship: “Both are important for making decisions about providing resources to an entity, and information about stewardship also is important for resource providers who have the ability to vote on, or otherwise influence, management’s actions.” In effect, SFAC-8 claims that stewardship is an aspect of decision usefulness for investment decision making, despite the widespread view heretofore that stewardship differs from decision usefulness. Like SFAC 1 [1978] and prior APB pronouncements, therefore, SFAC-8 [2010] downplays *stewardship* relative to *decision usefulness* as a basic objective of general purpose financial statements.³⁸ Moreover, to the extent that they considered stewardship, the FASB (and the APB) consider stewardship principally to stockholders and creditors, not to other interested parties, such as regulators and public policy makers.

³⁷ The APB, the predecessor to the FASB, also downplays *stewardship* relative to *decision usefulness* as a basic objective of general purpose financial statements, as noted above.

³⁸ SFAC-8 [2010a, para. BC1.28] notes that the FASB decided not to use the term *stewardship* in SFAC-8 “... because there would be difficulties in translating it [stewardship] into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.”

Interestingly, the European Financial Reporting Advisory Group [EFRAG, 2007], the [British] Accounting Standards Board, and a number of other European accounting standard-setters argue that stewardship (or accountability) should be viewed as a separate basic objective of financial reporting. The EFRAG [2007, para. 3.1] elaborates that "... the stewardship objective is about assessing management's competence and integrity including the success of their strategy in managing the business," and that an assessment of financial reporting "... was originally the primary objective of financial reporting under agency theory and is just as relevant today..." The EFRAG [2007, para. 7.1] notes that most [non-Anglo-American] respondents to their survey view stewardship [to stockholders] as a separate basic objective of financial reporting.³⁹

Importantly, pooling accounting developed in an era when many accountants and report users viewed stewardship as a separate basic objective of financial reporting, if not *the* basic objective; and where some commentators viewed stewardship not just to stockholders and creditors but also to other interested parties, such as regulatory authorities and public policy makers. For example, Ladd [1963, p. ix] notes that "... accounting has the vital social role of passing on to the public, information about the extent and uses of corporate powers." More recently, Rasche and Esser [2006, p. 252] define accountability more broadly as

... the readiness or preparedness of an organization to give an explanation and a justification to relevant stakeholders for its judgments, intentions, acts, and omissions when appropriately called upon to do so....
Accountability thus entails a mechanism of effective control by customers, citizens, and beneficiaries allowing an evaluation of the private or public good.

³⁹EFRAG [2007, para. 5.2] notes that some respondents view stewardship more broadly than accountability to also include the concept of responsibility, that stewardship connotes that management should be striving to act in the best interests of shareholders under current and future circumstances, whereas accountability connotes a backward looking and narrower concept than stewardship. However, most respondents to the Exposure Draft to SFAC-8 treat stewardship and accountability as interchangeable. EFRAG [2007, para. 5.2-5.5] favors replacing stewardship with accountability because accountability is the true reason for producing financial reports – i.e., to provide an account to the owners. Additionally, the term stewardship is old fashioned and for some only addresses information on corporate governance issues; and accountability is more easily translated to other languages than stewardship.

Others [e.g., Briloff, 2002; and Briloff and Briloff, 2010] concur that an important objective of financial reporting is to hold the management of large publicly owned corporations accountable to society, especially when there is a separation of ownership (i.e., stockholders) and control (i.e., management).⁴⁰

Pooling accounting developed in part to enable utility management to demonstrate its stewardship over the aboriginal cost of utility assets, not only to stockholders and creditors, but also to utility regulators, the courts, and public policy makers that were increasingly favoring aboriginal cost and prudent investment theory for rate making purposes.

Economic Policy as Another Objective: Presently, both the FASB and the IASB adhere to the quality of *neutrality* as an essential component of *faithful representation* of accounting information. For example, in *Statement of Financial Accounting Concepts No. 8, "Conceptual Framework for Financial Reporting: Chapter 3, Qualitative Characteristics of Useful Financial Information"* [SFAC-8 [2010b, para. BC3.29], the FASB notes that in developing financial accounting standards, it

... does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

The FASB explains more fully in Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information" [SFAC-2, 1980, paras. 98-100], that in developing accounting standards, its primary concern is the relevance and reliability of the resulting information, and that the resulting information should be free from bias towards a predetermined result.

When it develops new accounting standards, the FASB dismisses consideration of the effects of accounting standards on particular parties or particular behavior, including national economic and social policy, notwithstanding its understanding that accounting standards affect behavior. For example, in SFAC-8 [2010a, para. BC1.23], the FASB explicitly rejects suggestions that maintaining financial stability in national capital markets is a proper objective of financial reporting; it concludes that

⁴⁰However, Briloff [1967] and Briloff and Briloff, 2010] do not believe that pooling accounting facilitates stewardship, at least to stockholders and creditors. They are strong advocates of the purchase (or acquisition) method and strong critics of the pooling method.

such an objective would be inconsistent with its basic mission to serve the information needs of capital market participants.

However, as early as 1940, various commentators note that financial accounting information is the basis for significant decisions and policies in the economic, social, and political realm as well as in business affairs. For example, Greer [1940, p. v, italics added] notes that accounting is

... an important medium for the public expression of the important facts about our vast and complex commercial and industrial society. Where the accountant once was concerned merely with assisting the owners of a business to evaluate its operations in money terms, he now must recognize a broad *social responsibility*. His findings, and the manner in which he sets them forth, have become the *basis for significant decisions and policies, not only in business affairs, but in economic, social, and political matters*....

Similarly, Paton and Littleton [1940, pp. 2-3, italics added] note that

[g]reat corporations are quasi-public institutions for social cooperation [T]hey have a duty to government and to a price conscious public.... [T]he public aspects of corporations call for recognition by corporate management of public responsibilities; acceptance of such responsibilities calls for the development and use of corporate accounting standards.

One recent manifestation of the economic, social, and political role of accounting is the Chinese Accounting Standards Board (CASB), which opted to develop its own accounting standard on business combinations, [Chinese] Accounting Standards for Enterprises No. 20, "Business Combinations" [CAS-20, 2006], rather than adopt IFRS-3 (2004) verbatim. According to Baker et al. [2010, pp. 112, 114], the capital markets orientation of the IASB [and the FASB] largely ignores the existence of mergers [of related companies]; under IFRS [and U.S. GAAP], business combinations are viewed mainly as acquisitions resulting from arm's length bargaining between unrelated parties.⁴¹ In contrast, the political and economic focus of the Chinese standards setters emphasizes the existence of both mergers of related companies and acquisitions of unrelated companies; and

⁴¹ Almost as an aside, however, both the IASB [IFRS-3, paras. B1-B4] and the FASB [SFAS 141(R), paras. D8-D13] note that combinations of companies under common control remain subject to pooling accounting.

the need to have different methods of accounting for these different types of combination transactions. Baker et al.[2010, p. 112] contend that

Chinese standard setters sought to comply with IFRS insofar as those standards do not adversely affect economic development.... [but] ... apparently concluded that the IASB standard ... could have an adverse impact upon the industrial reorganization process taking place in China.

Consequently, Baker et al. [2010, p. 112] conclude that Chinese standard setters view the fundamental objectives of financial reporting somewhat differently than the IASB [and the FASB] because they consider the effect of accounting standards on economic development.

Pooling accounting developed in the United States in part to foster certain social and economic policies long before neutrality was enconced by accounting standard setters as a desirable qualitative characteristic of financial accounting information. Some advocates of pooling accounting argue that by adhering to aboriginal cost valuations of plant assets following stock-for-stock combinations of utilities, pooling accounting results in lower utility rate bases. In turn, the lower rate bases result in lower utility rates, which encourages greater use of electricity, enhances living standards, and fosters economic growth.

SUMMARY AND CONCLUSIONS

Through the years, pooling accounting was criticized as contrary to the decision usefulness objective of financial reporting and potentially misleading to stockholders and creditors in making investment decisions. Critics of pooling accounting argued that it does not provide decision useful information to stockholders and creditors because it grossly understates (1) the cost of stock-for-stock combinations; (2) the carrying values of the net assets of the acquiree; and (3) the expense incident to using acquiree net assets subsequent to the combination date.

From a historical perspective, however, there were some very good reasons for requiring or at least permitting pooling accounting for stock-for-stock business combinations when the method was developed in the 1940s. At that time, the basic objectives of financial accounting were viewed more broadly to include stewardship and decision usefulness for multiple users, including public utility regulators and public policy makers, not just stockholders and creditors. Pooling accounting developed

in part to satisfy the information needs of public utility regulators and public policy makers; it was a response to regulators' increasing use of aboriginal cost to measure the utility rate base for utility combinations, once they were permitted to do so as a result of U.S. Supreme Court decisions in the early 1940s. Lower utility rates resulted when utility rate bases were measured at aboriginal costs under pooling accounting rather than at fair values under purchase accounting. In turn, lower utility rates facilitated the attainment of certain social and economic goals; it encouraged more widespread use of electricity, lessened the drudgery of housework, and enhanced living standards and economic growth.

ADDENDUM

Recent Combinations of Health Care Organizations

Mathews (2012a) reports rising medical prices associated with increasing numbers of hospital systems combining with private physician practices. Although hospital representatives contend that the combinations make health care more efficient, rising prices result because insurance companies pay for medical services at hospital systems rates that are a lot higher than the rates for the same services performed at private medical practice facilities. For some procedures, such as imaging scans, insurance companies reimburse as hospital outpatient procedures rather than as practice office procedures. According to Mathews (2012a), the same procedure, sometimes performed at the same location, may double in price once a hospital system acquires the medical practice. Mathews (2012b) also reports that several states attorney-generals are investigating whether mergers of hospitals and doctor groups are pushing up prices.

Of course, this increase in third-party reimbursement rates is due to many other factors. According to Mathews (2012b), the primary factor may be the increased bargaining power of medical service providers due to the reduced competition by combining previously competing hospitals and private physician practices. Additionally—and unmentioned by Mathews—the increase in reimbursement rates may also be an artifact of the financial accounting for these combinations. Third-party reimbursement rates suppose to reimburse medical providers for the cost of providing services, including depreciation of medical facilities and equipment; and depreciation increases due to the increase in the depreciation base by using +purchase (or acquisition) method to record these combinations when fair value exceeds

aboriginal cost of these facilities and equipment. To that extent, third-party providers may push for aboriginal cost valuations of acquired facilities and equipment under the pooling method, at least for third-party reimbursement rate making purposes. To date, however, this accounting artifact issue has not been reported to be under active consideration by either third-party providers or states attorneys-general.

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