

CONCEPTS OF THE ENTITY THEORY

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Stanley W. Gustafson

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CONCEPTS OF THE ENTITY THEORY

By

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AN ABSTRACT

Submitted to the College of Business and Public Service
of Michigan State University of Agriculture and
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Approved

A handwritten signature in cursive script, appearing to read "G. L. Smith", is written over a horizontal line.

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ABSTRACT

There are presently many views of the business entity theory. Many of the concepts are conflicting even though they concern the same basic thought. This thesis will attempt to determine what these differences are and where they are in disagreement.

The paper was approached by studying the entity theory of corporate enterprise as presented by writers in fields of law, accounting, and by analyzing the position of stockholders, creditors, and government within the framework of an entity.

Three theories pertaining to the granting of authority to the corporation are recognized in law. They can be reduced to two general views. The association theorists hold that the stockholders associated together transfer to the corporation the rights necessary to carry on the business. This is basically a proprietary theory approach to corporate organization. The fiction theorists hold that the state gives the necessary authority to the corporation as an impersonal being to carry on business activity. In so doing the state does not recognize what already exists, as proprietary theorists hold, but, following the entity theory, the state created a new being separate and distinct from its stockholders and other interested parties.

In the field of governmental taxation the entity theorists claim there is no double tax because the income

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tax is levied on the corporation as a separate and distinct being from the stockholders and other interested parties.

Management also plays an important role in the concept of corporate entity theory. Although the typical management team is looked upon as performing the management function with authority delegated by the stockholders. Some writers consider management as an entity in itself rather than an employee of the stockholders. The part owners previously played in the corporation has been taken over by management. Therefore, the divorce of ownership and control seems to indicate the entity theory or a managerial approach to corporate enterprise theory.

The accountant, like the economist, is also divided as to which of the two theories to follow. We shall here be concerned with the various concepts of authors toward the entity theory. The entity theory is a managerial approach and the formula $A = L + P$ is appropriate because it demonstrates the oneness of the unit and shows the obligation to all the claimants together. This is distinguished from the proprietary approach in that the proprietary equation $A - L = P$ demonstrates the stockholders as the residual owners.

There are many conflicting ideas among authors in various fields regarding the proprietary and entity theories. If a more uniform approach to the ownership

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problem of the corporation would be adopted many of the
existing problems would automatically be resolved.

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DEDICATION

This work is dedicated to my wife, Joyce, my family, Deborah, Cynthia, and Andrew, and my parents, Palmer and Erma Gustafson, whose constant support and encouragement, were responsible for any accomplishments that may have been achieved.

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CHAPTER I

PURPOSE, SCOPE, AND DEFINITIONS

Purpose

Accounting is the ". . .art of recording, classifying, and summarizing . . . transactions and events . . ." ¹ The obvious question that immediately becomes material is "recording, classifying, and summarizing transactions for whom"?

Traditionally there have been two so called "theories" of accounting. These two theories are based on two different approaches that may be taken in viewing accounting questions and propositions. ² One of these theories is referred to as the "proprietary theory" and the other is generally called the "entity theory." The differences between the two theories are based for the most part on (1) the nature of the business enterprise, (2) the

¹Accounting Research Bulletin No. 58.

2. Recently a third theory has been suggested--"The Fund Theory of Accounting." See William J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports (Chicago, Illinois: The University of Chicago Press, 1947), p. 1.

viewpoint to be taken of the fundamental accounting structure, and (3) relative emphasis to be placed on legal, economic, and accounting structure.³

The purpose of this paper is to examine the "entity theory" as it pertains to accountancy. In order to achieve this goal it has been decided to explore the views of an entity as followed by legal and accounting interests. It is also purposed to include the views of other interested groups such as, the stockholders, management, creditors, et al.

After examining the entity theory consideration will be given to some of the more important and controversial ramifications of the theory. The conclusion will include a review of the relative merits of the entity concept and conclusions will be drawn based upon the material covered.

Scope

The research for this paper was done within the confines of the Michigan State University Library, the Michigan State Library, and the Lansing Public Library. It has included opinions of Accounting, Legal, and Economic authors writing in journals, periodicals, books and case studies. A good deal of the opinion of the present writer was obtained

³G. H. Newlove and S. Paul Garner, Advanced Accounting (Boston: D. C. Heath and Company, 1951), p. 20.

through various classes in accounting with special emphasis upon the Accounting Theory Seminars offered at Michigan State University.

Definitions

The term "concepts" shall refer to ideas, thoughts and considerations of the entity as expressed by numerous authors. It will be used to label these author's conceptions of the entity. The simple definition of an entity such as is found in Webster's dictionary will not suffice. "En'ti-ty--A being; esp., a thing which has reality and distinctness of being either in fact or for thoughts; as, to view the state as an entity."⁴ Naturally accounting has special connotations ascribed to the word entity which are not considered by an ordinary dictionary. But even here the entity seems to have many definitions depending on which entity you are speaking. For the purpose of this paper the accounting equation will be used in the discussion of the entity theory. The difference of opinion as to what constitutes an entity in theory will be discussed.

The Entity Theory Via the Accounting Equation

There are two generally accepted methods of stating the accounting equation. The reason for the difference in

⁴Merriam-Webster, Webster's New Collegiate Dictionary (Springfield, Mass.: C. Merriam Company, 1953), p. 275.

stating the seemingly identical equation in two different ways has been traditionally given as one of viewpoint. It is this viewpoint that interests us here. The first point of view is that $A - L = P$.⁵ The second point of view says that the equation should read $A = L + P$ or $A = E$.⁶

The former equation is viewed as the proprietorship equation and the latter two equations are viewed as the entity equations. Algebraically these formulas are identical. If we accept this statement then we are in a dilemma. How can two formulas containing the same terms and differing only in signs possibly result in two different theories if the results are the same? Obviously they are not the same, because, if they were we could not possibly have two different theories.

It has been stated that the difference was one of viewpoint. The point is this, the determination of profit under proprietary theory involves the measurement of proprietor net worth at two points in time; that is, the change in investment of the proprietor over time is established by the measurement of net worth at the beginning and the close of the period.⁷ However, corporate

⁵Terms for these symbols are as follows: A = Assets, L = Liabilities, P = Proprietorship.

⁶The "E" in this last method of stating the accounting equation represents the word "equities."

⁷Vatter, op. cit., p. 4.

proprietorship arises from numerous investments made at various times. The trouble arises because the prices paid for corporate stocks on the investment market reflect anticipations toward future activities of the corporation.⁸ Obviously it is nigh impossible for the accountant to apply the proprietary theory to the corporation because he would be required to reflect all the changes that occur in the valuation of proprietorship.

This provides the necessary impetus for a different theory of accounting. The entity theory takes up the gap by imagining a separate entity entrusted with the powers of the proprietor. This set of circumstances helps explain why the two accounting equations reflect a difference in viewpoint. The proprietary equation as stated, $A - L = P$, suggests that the emphasis be placed on the determination of the proprietor's interest since the usual treatment in solving an equation is to solve for the right side of the equal sign. The entity equation, $A = L + P$, suggests that the emphasis be placed upon the combination of both the creditors and the proprietors.

It has also been suggested that the system of double entry suggests that the entity is automatically designed.

Double entry is based upon the concept of duality of a single business property. This duality is created through the separation of business properties

⁸Ibid., p. 5.

from their actual owners by placing these in the possession of a fictitious business entity which holds and operates such properties under an assumed trust arrangement between the business entity and the legal owners. . . . Because of this separation of the properties from the legal owners, and because of the varying legal status of these owners, it becomes necessary for the fictitious business entity to account for both the kinds of goods or things making up the property in its possession and for the kinds of ownership claims attaching to those goods.⁹

W. A. Paton and A. C. Littleton provide the definition which will be used in understanding the entity theory.

The business undertaking is generally conceived of as an entity or institution in its own right, separate and distinct from the parties who furnish the funds, and it has become almost axiomatic that the business accounts and statements are those of the entity rather than those of the proprietor, partners, investors, or other parties or groups concerned.¹⁰

In way of contrast a definition of the proprietary theory stated by Nelson B. Seidman is offered, "the proprietary concept views the corporation as having an agency relationship with its stockholders."¹¹

The Nature and Definition of a Theory

It may be said that the business of accounting theory is to examine beliefs and customs critically, to clarify and extend the best from experience, and to direct attention

⁹Warner H. Hord, "A Neglected Area of Accounting Valuation," The Accounting Review, XVII (October, 1942), 337.

¹⁰W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Columbus, Ohio: American Accounting Association, 1940), p. 8.

¹¹Nelson B. Seidman, "The Determination of Stockholder Income," The Accounting Review, XXXI (January, 1956), 64.

to the genesis and outcome of accounting work.¹² Theory's explanation may be an account definition that will help us to know why a certain transaction fact must fall in one category rather than another. Practice is fact and action: theory consists of explanations and reasons.¹³

The following are some of the features or criteria of good accounting theory:¹⁴

1. Theory should possess the attributes of clarity, orderliness, purpose, and pattern.
2. Theory should be in harmony with observable and acceptable (perhaps objective) factors and conditions.
3. Theory should reflect impartiality and should exclude individual bias.
4. Theory should reflect consistency in thinking.
5. Theory should contain some perspective for purposes of formation.

It is clear that accounting theory cannot justifiably be said to consist of scientific explanations. There are

¹²A. C. Littleton, Structure of Accounting Theory, American Accounting Association, Monograph No. 5 (Menasha, Wisconsin: George Banta Publishing Company, 1953), p. 132.

¹³Ibid., p. 132.

¹⁴W. A. Paton, Recent Developments in Accounting Theory and Practice (Cambridge, Mass.: Harvard University Graduate School of Business Administration, Bureau of Business Research, 1940), p. 1.

no immutable laws of accountancy comparable to the immutable laws of Nature; there are no laboratory tests and controlled experiments to yield data which may be set up as mathematical formulas to express existing relationships. Yet we must grant that knowledge is involved in accountancy and that significant relationships exist between the ideas which constitute accounting knowledge.¹⁵

In regard to the term "accounting theory" the following definition is offered:

Accounting theory is a body of Accounting thoughts which are logical and coherent and concerned with the truth about basic economic facts. It accomplishes an understanding of the nature and purpose of the phenomena involved and their effect and functions.¹⁶

Thus the stage is laid for an investigation into various concepts of the entity and a few of the ramifications of the accounting entity concept.

¹⁵Littleton, op. cit., p. 135.

¹⁶Roland W. Funk, "Recent Developments in Accounting Theory and Practice," The Accounting Review, XXV (July, 1950), 293.

CHAPTER II

LEGAL VIEWS OF THE ENTITY

The Fiction Theory of the Entity

There are three different theories of the separate and distinct legal entity: the "fiction theory," the "concession theory," and the "realistic theory."¹ The theory of the fictitious legal person apparently originated with Pope Innocent IV in the thirteenth century.² The doctrine was stated as the reason why corporate bodies or "universitas" could not be punished or excommunicated--they had neither a soul nor a body and had being only in "abstracto."³ A leading proponent of this view was the German law scholar, Savigny, who wrote in the early nineteenth century and adopted the theory based on his study of early Roman law.⁴

¹Robert T. Sprouse, "Legal Concepts of the Corporation," The Accounting Review, XXXIII (January, 1958), 38.

²Ibid., p. 38.

³John Dewey, Philosophy and Civilization (New York: Minton, Balch, and Company, 1931), pp. 152-159.

⁴A complete discussion of the Savigny theory may be found in Frederick Hallis, Corporate Personality: A Study in Jurisprudence (London: Oxford University Press, 1930), Part I, Chapter 1.

The Concession Theory of the Entity

The "concession" theory states that a corporation cannot arise out of a mere agreement between the members but can exist only as a creature of the state, the result of the gift of the franchise by the state. The concession theory has also been expounded in judicial decisions. For example, in a United States Supreme Court case, on the grounds that the corporation might be incriminated, an individual who was an officer of a corporation refused to produce documentary evidence, consisting of correspondence, records, and accounts of the corporation, which had been subpoenaed by a grand jury. Associate Justice Henry Billings Brown delivered the opinion of the court:

. . .the corporation is a creature of the State. It is presumed to be incorporated for the benefit of the public. It receives certain special privileges and franchises, and holds them subject to the laws of the state and the limitations of its charter. Its powers are limited by law. It can make no contract not authorized by its charter. Its rights to act as a corporation are only preserved to it so long as it obeys the laws of its creation. There is a reserved right in the legislature to investigate its contracts and find out whether it has exceeded its powers. It would be a strange anomaly to hold that a state, having chartered a corporation to make use of certain franchises, could not in the exercise of its sovereignty inquire how these franchises have been employed, and whether they had been abused, and demand the production of the corporate books and papers for that purpose.⁵

The "concession theory and fiction theory" are thus very closely related. However, it is unfortunate that the courts do not agree.

⁵Hale v. Henkel, 201, U.S., 74-75 (1906).

The Realistic Theory of the Entity

A third group argues that the corporate entity is separate and distinct from the corporation stockholders and officers but further insists that it is not artificial, but natural, not fictitious, but real. It is maintained that the corporation has a will of its own and a volition identifiable from the individual volitions of the stockholders.⁶ It is believed that the real entity comes into existence when the group comes into existence, and it does not depend upon the state to create it even though its legal status must necessarily depend upon recognition by the state.⁷ The leading proponent of this view was another German scholar of the law, Otto van Gierke, who lived near the end of the nineteenth century.⁸ An example of the disagreement of the courts can be found in a 1943 case heard before the Supreme Court of Minnesota. The case involved two Minnesota newspaper publishing companies. One had transferred all of its assets to the other and the actual printing of the old company's paper was transferred to the purchasing publisher. Two employees brought suit for severance pay based on the premise that the sale of the

⁶Sprouse, op. cit., p. 39.

⁷Ibid., p. 39.

⁸Otto Friedrich van Gierke, Political Theories of the Middle Age, trans. Frederic William Maitland (Cambridge: Harvard University Press, 1900).

assets constituted a dismissal. The defendant newspaper defended on the ground that they continued in existence as the holder of one-third of the stock of the purchasing company. The court deciding in favor of the employees, said:

Defendants position becomes untenable when we consider that it and the new Star-Journal and Tribune Company are distinct and separate entities. The nature of a corporation is such that it is a entity separate and distinct from the body of its stockholders. . . . It is not a fiction of the law but a real legal unit possessing individuality and endowed by the law with many of the attributes of persons. . . . The transfer of interest was as complete and effective as it would have been if the Tribune Company had received no stock in the Star-Journal Company.⁹

The Result of Three Views of the Same Basic Legal Concept

These three theories--the fiction theory, the concession theory, and the reality theory--may be considered together because they are in agreement as to the separate and distinct nature of the legal entity.¹⁰ It has been said that legal precedent may be found to support all sides of a legal controversy. The propriety theory of accounting requires that the corporation be viewed as an association of individual owners; the entity theory of accounting is based upon the notion that the existence of the corporation is quite separate and distinct from the stockholders. These

⁹Mathews et al. v. Minnesota Tribune Co., 10 NW (2d) 232 (1943).

¹⁰Sprouse, op. cit., p. 40.

two concepts of the corporation are diametrically opposed, yet, each has found clear support in the law. Contrary to what seems to be popular belief, reference to the experience of law is not apt to facilitate the evaluation of accounting proposals the foundation for which rests upon a particular concept of the corporation.¹¹ The obvious conclusion is that proposals of accounting theory must be supported by something other than legal precedent.

The Accounting Entity vs The Legal Entity

One of the important implications of the two theories under discussion is concerned with the problem of whether the accounts of all forms of business organization are to be kept on a consistent basis. Are the same concepts of capital, profit, cost, expense, periodic income, and loss to be maintained in spite of legal authority to the contrary?

Accountants have upon many occasions commented upon the good and bad influences of the law in its relationship to accounting practices and procedures, but there seems to be no great tendency to disregard legal points of view.¹² Nevertheless the fact remains that there is a definite

¹¹Ibid., pp.48-49.

¹²Newlove and Garner, op. cit., p. 23.

distinction between an accounting and a legal entity. The purpose of accounting is different from that of law. H.

McCredie writing in The Accounting Review has recently said,

The separation into entities must be for the purpose of accounting and thus the entities are accounting entities. Difference in entities may be relevant for other purpose, e.g. legal or economic, but may not be relevant in accounting. This is seen when legal entities and accounting entities are compared. A child, that is a person under 21 years, can be a different legal entity from an adult, yet for purposes of accounting the age of the person concerned is irrelevant. In like manner the mental capacity or sex may determine a legal entity but in accounting be immaterial.¹³

Attempts to develop coordinated and integrated structures of accounting theory have been a step in the direction of consistency.¹⁴

It is felt that accounting has a body of principles and enough sound theory to stand by itself. This view has been repeated on occasions. Walter G. Kell has said, "Legal sanction is not necessary for accounting purposes. The concept of an accounting entity should be determined entirely upon accounting reasons."¹⁵

¹³H. McCredie, "The Theory and Practice of Accounting," The Accounting Review, April, 1957, p. 216.

¹⁴See page 39 of this paper.

¹⁵Walter G. Kell, "Should the Accounting Entity be Personified?," The Accounting Review, XXVIII (January, 1953), 41.

The logic behind this statement is sound. The only unfortunate consideration is the lack of authority to effect this proposition. Until this question can be resolved between accountants and courts of law the legal entity will prevail no matter what are its limitations or inconsistencies.

CHAPTER III

THE ENTITY THEORY AND ECONOMICS

The theory of the business entity has had little support from the field of economics. The reason that so little attention has been paid to this legal and accounting theory is found in the purpose of the study of economics. In their Principles of Accounting, Kohler and Morrison state:

The economist has the social point of view. He analyzes the individual transactions of particular enterprises but does so principally in order to determine the fundamental principles of markets, prices, production, consumption, and distribution, and their social consequences.

On the other hand, the accountant, employed by the management of a business or its creditors, analyzes business transactions with the express object of interpreting their effect on the particular business enterprise.¹

Thus it is evident that the theory of the entity per se has been given little attention by the economist while at the same time it has received much attention from the accountant and the law.

An expanded point of view between accounting and economics is the topic of much discussion currently and the foreseeable future could see this circumstance greatly

¹Eric L. Kohler and Paul L. Morrison, Principles of Accounting (New York: The McGraw-Hill Book Company, Inc., 1931), p. 10.

changed. The accountant has seemed to broaden his horizon and is more likely today to regard his work more from the social viewpoint than he did in the past.² W. A. Paton has provided a broader concept of accounting which defines the primary function of accounting:

In a broad sense accounting has one primary function: facilitating the administration of economic activity. This function has two closely related phases: (1) measuring and arraying economic data; (2) communicating the results of this process to interested parties.³

In the same way the broadening of the field of economics has included developments which do not have the social viewpoint but which are oriented to the individual and the individual business enterprise.

Of all the arguments which accountants and economists have entered probably the one which has remained without solution is the determination of income. Since it is the income statement which seems to be the primary aim of the entity concept it might be well to point out some of the differences here. Robert B. Bangs has singled out some of the differences.

In the main the differences between the net income boundary lines drawn by accountants and economists may be said to result from:

1. Differences regarding the functional relationship between the recognition of gross revenues.

²Morton Becker (ed.), Handbook of Modern Accounting Theory (New York: Prentice-Hall, Inc., 1955), p. 44.

³W. A. Paton, Essentials of Accounting (New York: The Macmillan Company, 1949), p. 1.

2. Differences as to the relative importance to be assigned to original and replacement costs.

3. Differences in the treatment of capital gains and losses.

4. Differences in point of view as to the proper horizon of expectations which should be reflected in current income figures. If these differences are borne in mind adjustments of any of the main income concepts of economics or accounting to the remaining ones presents no insoluble problem. It is important, however, to see clearly each step in passing from the income concept of modern economic theory to those recognized in accounting practices. When the precise nature of the required adjustments is made plain to both economists and accountants, economic analysis and accounting practice should gain equally in clarity and logical alliance.⁴

John B. Canning attempting to achieve the same sort of analysis has the following things to say about accounting theories and economics;

The economist is concerned with the incomes of persons, of groups of persons, of society in general. The accountant is concerned with income as it emerges in enterprise relations; he undertakes to show to whom the beneficial interest in income runs, but he is not concerned with the use to which the beneficiary turns his income. The ultimate concern of the economist is with the subjective appreciation of income; objective valuations of income are to him indexes of that appreciation. The accountant is not, as an accountant, concerned with subjective appreciations at all; his care is devoted to determining a proper dollar measure. Nor has the accountant anything to do with the problem of distribution. To be sure, he endeavors to express correctly the amounts paid to each person and the reasons for the payment; but whether a particular payment is an element of what the economist calls rent, or interest, or wages, or profits, is a proper matter of indifference to him. He has concluded when he correctly describes the class of enterprise operation or transaction that has given rise to the payment. The

⁴Robert B. Bangs, "The Definition and Measurement of Income," The Accounting Review, XV (September, 1940), 371.

great preponderance of enterprise income, nowadays, inures in the first instance to corporations. The accounting for income of corporations differs in no essential way, so far as accounting for the income of enterprises in which the proprietor is a natural person or persons. The economist, on the other hand, is not ultimately concerned with the incomes of corporations at all; he is interested in the matter of what natural persons benefit by these incomes (and who is injured by them), as well as the question of when the benefits become available to natural persons.

With social income, as the economist conceives it, the accountant has nothing to do. Whether the income arising out of enterprise affairs is associated wholly with a concomitant beneficial service rendered to society or is totally divorced from such a service, is not for him to inquire into. Whether a profit is a wholly speculative one gained at the expense of another, losing speculator, or is a profit arising from the sale of goods that allow a large consumer's surplus to all purchasers, is no concern to the accountant.

The accountant pays little attention to what the economists call "real income" and "final objective income," in contradistinction to money income. Indeed, in what accountants explicitly refer to as income or expense, they pay no attention to changes in purchasing power at all; their income is dollar income. The amount of this dollar income, as will readily be seen, is not affected by changes in the purchasing power of money, but as we shall see, the influence is due to the methods of valuation employed and not to a conscious attempt to set up a "purchasing-power accountancy."⁵

Much of the trouble between accountants and economists has been the failure of each to properly agree on the term "income," however, strangely enough this shortcoming is not only a difficulty between the two but also a difficulty within the professions themselves. As has already been

⁵John B. Canning, The Economics of Accountancy (New York: The Ronald Press Company, 1929), p. 91.

stated, accountants using the entity concept view "net income" differently than do those accountants who hold the proprietary concept. Obviously then it will take an agreement within the profession of accountancy as to what is net income before any agreement between accounting and economics may be reached, if an agreement is necessary at all. Since the accountant and economist seem to have different goals it is questionable if agreement is useful for any other purpose than understanding.

The entity theory as has been portrayed seems to have little to do with the economic theories usually presented and hence economic theory will receive little future reference in this work.

CHAPTER IV

ACCOUNTING VIEWS OF THE ENTITY

The Two Theories of the Accounting Entity

There are two common methods of viewing the fundamental accounting structure. One is the "entity theory" and the other is often called the "proprietary theory." The difference between the two is a difference in viewpoint.

In the entity theory the proprietor, regardless of how closely he may be identified with the business, regards himself as a person separate and distinct from the business.

In the proprietary theory this is not true. It becomes necessary, therefore, to adopt another explanation of the proprietor's account. This is done by assuming that bookkeeping represents an accounting for his own property.

In one case the central figure is the entity, and in the other the central figure is the proprietor.

The ancient writers used the entity convention in the same way as the moderns. Paciolo's explanation quoted by Peragallo,¹ mentions that

a branch of a store is in effect the debtor of the proprietor, so that the latter may debit the store

¹Edward Peragallo, Origin and Evolution of Double Entry Bookkeeping (New York: American Institute Publishing Co., Inc., 1938), p. 99.

for all he takes out of it, just as he would do in the case of a debtor who contracted a debt and subsequently paid it.

A. C. Littleton has stated the essentials of the entity convention in the following words:²

Thus to the reporting (record-keeping) person the account with a "proprietor" was not different in principle from an account with a lender; in fact, a lender often took the form of a proprietor to avoid the appearance of being a lender. To the active manager (in contrast to the silent partner) of the trading ventures so common in the fifteenth century, there were two elements present: (a) kinds of property for which he was accountable and (b) sources of property to which he was accountable; profit was but an additional "indebtedness" to the sources of the property in use.

Porter and Fiske³ define profit from the entity viewpoint as "a proprietary claim to an excess of values received over values given up in exchange." Their use of the word "claim" in this connection clearly intimates the adoption of the entity viewpoint.

MacFarland and Ayars⁴ take a more definite stand, saying that: "The concept of an enterprise as a unit or undertaking for which financial records should be classified and kept, summarized, and interpreted is absolutely essential in accounting."

²A. C. Littleton, Accounting Evolution to 1900 (New York: American Institute Publishing Co., Inc., 1933), p.194.

³G. H. Porter and W. P. Fiske, Accounting (New York: Henry Holt & Company, 1939), p. 37.

⁴G. A. MacFarland and R. D. Ayars, Accounting Fundamentals (New York: McGraw-Hill Book Company, Inc., 1936), p. 1.

In discussing the two theories, Husband and Thomas⁵ assert:

Accountants may be divided into two groups: (1) those who claim that the proprietor owns all of the assets but owes certain amounts to creditors, and (2) those who hold that both liabilities and proprietorship are merely claims against the assets. The former point of view, which is the older of the two, is held by the greater number.

W. A. Paton mentions,

Another important result of using the enterprise as the focus of attention has been the development of the going concern assumption, with derivative stressing of the interpretation of business operation as a continuing stream of activity. The increasing consideration being given to income measurement and reporting is presumably a manifestation of the influence of the business-enterprise, managerial point of view.⁶

F. Sewell Bray supports this view ten years later by saying:

. . . we cannot begin to shape accounts until we have conceived either the unit of organized activity, or the transactor whose history and condition we wish to measure and portray in financial terms. Plainly we must look at the transactions which take place under one roof, whatever that roof may be. I therefore regard the entity notion of theory as primary. . . .⁷ It may be a firm, a person, or an isolationist; . . .

⁵G. R. Husband and D. E. Thomas, Principles of Accounting (New York: McGraw-Hill Book Company, Inc., 1936), p.

⁶G. O. May, Sir Laurence Halsey, and W. A. Paton, Dickinson Lectures in Accounting (Cambridge, Mass.: Harvard University Press, 1943), p. 90.

⁷F. Sewell Bray, Four Essays in Accounting Theory (New York: Oxford University Press, 1953), p. 4.

Authorities Who Oppose the Entity Concept

A recognized early authority, Sprague⁸ took a decided stand against the entity theory. While recognizing certain of its advantages, he failed to see that "it justifies the inclusion of proprietorship among the liabilities." He thought that the entity did "not stand in the same relation to its proprietors or its capitalists as to its 'other' liabilities. It would seem more appropriate to say that it is 'owned by' than 'owes' the proprietors."

Elsewhere⁹ he said:

Thus the right-hand side of the balance sheet is entirely composed of claims against or rights over the left-hand side. "Is it not then true" it will be askt [sic], "that the right-hand side is entirely composed of liabilities?" The answer to this is that the rights of others, or the liabilities, differ materially from the rights of the proprietor.

Henry Rand Hatfield has consistently used the proprietary rather than the entity approach in his writings.

Legal dislike of the overextension of the entity concept is reflected by such comments as this one of Judge Oliver B. Dickinson.¹⁰

The relation of corporation and shareholder is not the relation of debtor and creditor and creditor otherwise, perhaps, than in a secondary and remote sense.

⁸Charles E. Sprague, The Philosophy of Accounts (New York: The Ronald Press Company, 1913), p. 49.

⁹Ibid., p. 46.

¹⁰Quoted by Robert H. Montgomery in "Dealings in Treasury Stock," The Journal of Accountancy, August, 1938, p. 112.

Canning¹¹ discussed the entity theory as follows:

The accounts, it is said, constitute an accounting by this entity to all who have commercial and financial relations with it. Some writers even profess that, in the case of corporate enterprise, the entity may be more than a figure of speech. This they do by making the blunder of identifying the shareholders as the proprietor and making the corporation correspond to the entity.

With this somewhat vague and obscure point we proceed with the two different views of the accounting entity, the personal entity and the impersonal entity.

A Comparison of the Two Concepts of the Entity

The personal entity. The entity convention has predetermined the design of the accounting mechanism, especially in the area of what net profit is. The actual origin of the entity theory seems to have its beginning with the double entry system of bookkeeping. The origin of double entry bookkeeping is not definitely known. Some are of the opinion that double entry bookkeeping may have originated from the relationship between the Roman slave and his master. Peragallo¹² suggests no more than that double entry: "may have been present in embryonic form in the Roman bookkeeping system."

¹¹Canning, op. cit., p. 55.

¹²Peragallo, op. cit., p. 3.

Whether this is true is immaterial. As an explanation it is completely logical and satisfactory in that the entity is best described by using the slave illustration. A story told by A. C. Littleton in Accounting Evolution to 1900 explains that it was beneath the dignity of a Roman patrician to engage in trade. Buying, selling, and other practical matters of business were considered unfitting for the free citizen, who found it necessary to engage in business by proxy. Since many of the Roman slaves were well educated and very able, many citizens advanced money to them which the slaves in turn would loan at interest. The slave himself could own no property, therefore, property merely changed hands but not ownership.

When the business transactions were at all complex, it was necessary for the slave to keep records. This relationship of master and slave to keep records introduced a certain pattern of accounting which has persisted to the present day.

The effect of separate personalities. Because the slave was a person separate and distinct from the master, the record he kept was his own personal record. It reflected the slave's viewpoint toward the business in general. Despite the personal viewpoint of his record keeping, the slave was owned and controlled by the master.

These two characteristics of (1) ownership and control, and (2) separate personality and viewpoint, represent

so logical and satisfying an explanation of the accounting mechanism as to justify the adoption of the entity convention regardless of positive historical proof.

It is convenient to think that the slave had no power of initiative, no opportunity to exercise independent business judgment; that he merely followed directions.

Because the slave was a human being with a personality and a viewpoint of his own, he could not fail to regard his master as a person separate and distinct from himself. His records, therefore, were the kind of records any man might make in dealing with another.

When the master advanced him a certain sum of money, it was natural for the slave to adopt a record keeping viewpoint that he personally owed that amount to his master. When the master demanded the return of the money, it was equally as natural for the slave to consider that he was "paying the money back."

Any increase in the amount of funds held by him represented an increase in the amount of his debt to his master, any decrease represented a decrease in the amount of his debt to the master.

The relationship between a Roman slave and his master suggests that charge and discharge concept upon which all double entry accounting rests. The slave is charged with certain funds advanced to him by his master and also with any increase of those funds due to prudent investment. He

is discharged of his responsibilities by repaying funds to his master. The slave neither benefits nor suffers because of increases or decreases in the funds transferred to him.

In this master-slave relationship are two basic accounting concepts: (1) that of keeping records in terms of money rather than physical things, and (2) that of an entity as separate and distinct from proprietorship. This is in essence is the personal viewpoint of the entity. Our modern day corporation can be looked upon as having the same basic structure as the Roman slave in relation to its stockholders or its master.

The impersonal accounting entity. The only thing lacking in our conceiving our modern day corporation as a personal entity is its complete lack of personal attributes. Chief Justice Marshall defined the corporation as,

. . . an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence. . .¹³

Sole proprietorships and partnerships may also be regarded in the same manner. Accounting records have been written from the viewpoint of an entity until now it has become an accounting convention. The value of this concept cannot be emphasized enough. Professor William A. Paton as

¹³Dartmouth College Case, 4 Wheaton, 518 (1819).

Dickinson Lecturer at Harvard University in 1940 said, "I have always been a supporter of the business-entity concept of accounting and have no desire to 'change my tune' at this late date."¹⁴ In particular, this conception has been useful as a means of fostering the development of the managerial point of view, and thus encouraging progress in the field of cost accounting. In this area there has been a truly remarkable advance, and it is difficult to see how the narrow limits of proprietary theory can be reconciled to the broader field of enterprise accounting.

Of all the names that have been applied to this impersonal, artificial, intangible being, the word "entity" seems to be most appropriate. Such substitutes as "economic unit," "accounting unit," "enterprise," and "the business," have been used.

"The business" seems to be the one most often applied. A person commonly speaks of his business as being something separate and distinct from himself. If he is engaged in more than one business he speaks of each as though it were a separate entity.

The term "accounting entity" would probably be most desirable because it clearly indicates that the artificial person is conceived in relation to accounting records.

"Entity" is preferred to "unit" because the word "unit" is commonly employed in other meanings in such phrases as "unit costs" or "a unit of production."

¹⁴W. A. Paton, Dickinson Lectures in Accounting (Cambridge, Mass.: Harvard University Press, 1943), p. 1.

Description of the impersonal entity. The entity has been described as being as soulless and automatic as a slot machine. Its activities are in response to the demands of proprietorship either direct or through appointed managers. In and of itself the entity makes no profits, suffers no losses, is incapable of enjoyment, sorrow, greed, or other human emotions which influence those who direct it.

There are various types of business entities, for example, an association or club differs materially from a bank or a steel corporation. However, there is no accounting difference between them. The only prerequisite for an entity is a double-entry set of books. If a social club maintains no double entry record then no accounting entity exists although the association may be conceived as some other sort of entity.

In business organizations having departments or plants each possessing its own set of double entry records then each is a separate accounting entity.

Some authorities are willing to accept the entity convention for corporations but not partnerships; or accept the entity convention for large or moderate-sized business units but not for small ones, or where the management and proprietorship are so merged that it seems ridiculous to think of the business as having an artificial personality.

W. A. Paton has pointed out that: "A blind insistence on the independence of the business entity in such situations

is bound to lead to unreasonable conclusions."¹⁵ Elsewhere he insisted that: "To conceive of the business of the pop vendor at a football game as having any distinct existence, to take an extreme example, would obviously be quite fantastic."¹⁶

His objection to the entity convention here may be due to an assumption that the pop vendor must himself recognize the entity convention. This, of course, is not true. The entity exists only in relation to double entry book-keeping(as has been said elsewhere) and most students learn the rules and practices of bookkeeping without ever having considered the artificial person whose viewpoint determines the accounting equation.

This is the impersonal entity as it now is recognized by accounting authors.

Table I will show a comparison of the Entity and Proprietary theories of accounting. The material displayed was taken from the advanced accounting text of G. H. Newlove and S. P. Garner who explain that the chart was adopted in part from A. C. Littleton, Stephen Gilman, and G. R. Husband.

¹⁵W. A. Paton, Accounting Theory (New York: The Ronald Press Company, 1922), p. 476.

¹⁶Ibid., p. 477.

TABLE I

A COMPARISON OF THE TWO THEORIES OF ACCOUNTING

	Proprietary Theory	Entity Theory
1. Primary purpose of accounting	Primarily concerned with the accounting by the owner (or owners) for his own property in detail and in total.	Primarily concerned with the accounting to "outsiders" (owners and creditors) for all property entrusted to the business (as an entity), and dedicated to its purposes.
2. Relation of assets to liabilities	Proprietor owns all the assets but owes certain amounts to creditors.	The business entity owns all the assets; both liabilities and proprietorship are claims against the assets.
3. Form in which the accounting equation is to be written.	Assets - Liabilities = Proprietorship	Assets = Liabilities, or, Assets = Liabilities + Proprietorship, or, Assets = Equities, or, Assets = Investments
4. Nature of capital	The owner's contribution to the enterprise, plus the net gains not withdrawn. (Source of property active in the enterprise is important.)	The sum total of all property (both tangible and intangible) active in carrying out the business or entity purposes.
5. Source of capital	Investment of the owner or owners, plus gains not withdrawn. (Source of property active in the enterprise is important.)	Investment of the owners (plus gains not withdrawn), plus property purchased by incurring short or long term debts, plus leaseholds, plus gifts, etc. (Source of property is not of importance.)

TABLE I (continued)

	Proprietary Theory	Entity Theory
6. Distinction between owners and creditors.	Careful differentiation necessary.	No distinction necessary insofar as the theory is concerned.
7. Nature of liabilities	Liabilities are negative properties, which must be sharply defined and separated in the accounting process.	Liabilities considered to be capital sources as much as so-called "proprietary investment." The claims against the assets are so difficult to classify that there is no particular accounting purpose served in making sharp differentiations. Considers such differentiations as being purely legalistic.
8. Nature of profits.	Profits are increases in net assets, that is, increases in the net figure of positive and negative properties.	Profits represent an increase in the nonlegal liability of the entity to the proprietor or proprietors due to an excess of recoveries over outlays. The term "net income" is often used.
9. Importance of source of profits.	Source is of no particular importance--any increment to proprietorship. Source may include both usual and unusual increments.	Source is of great importance, as only skillfully conducted business operations result in "profits."
10. Importance of periodicity as to profits.	Of no great importance.	Amount to be called "net income" for any period is of major significance. Periodicity factor is of greater importance than over-all, long term, accretions.

TABLE I (continued)

	Proprietary Theory	Entity Theory
11. Relation of expenses to assets.	Expenses are viewed in somewhat the same way as losses, that is, deductions from proprietorship. Assets and expenses have only a remote relationship.	Expenses and assets are in the same category, that is, profit-making media. The difference between the two is in the time of appropriation in relation to specific units of income.
12. Nature of assets.	Assets are objects or realizable claims which are awaiting sale to satisfy creditors. Assets are essentially debt-paying media.	Most of the assets are outlays which have been made for productive reasons. They await appropriation or use for business purposes.
13. Distinction between owners and the "business."	No distinction made. The business is not an entity.	Sharp distinction made. The owners and the business are separate; the business is an entity.
14. Centers of attention.	(a) Balance sheet values, particularly short-term realizable values. (b) Legal relationships of various parties interested in the firm, that is, ownership and debts. (c) Relation of depreciation to the preservation of capital.	(a) Association of costs and returns from costs. (b) Periodic income reporting. (c) Going-concern valuation concepts, such as depreciation-a-cost-element and the pricing of materials into production. (d) Distinctions between costs, expenses, and losses. (e) Distinctions between operating and nonoperating items.

CHAPTER V

RAMIFICATIONS OF THE ACCOUNTING ENTITY

General

There are many items, classifications, and analyses of transactions which are common to both the proprietary and entity concepts of accounting. For example, it is common for even the proprietary theorists to limit their accounting function to only the business transactions of the proprietor. This would suggest that there is an element of the entity theory within the proprietary concept. It is also equally as common for the entity theorist to speak of the stockholders as "proprietors" and to compute their "net worth" in the entity. This would suggest an element of the proprietary theory within the entity concept. Yet it is also common for both theorists to claim that they follow one or the other of the concepts religiously. Unfortunately, this is not true.

Were it true, accounting would have clear-cut problems. But the situation today suggests that bits of each theory are found interwoven within each other. Because of this fact the areas of greatest controversy between the two concepts have been chosen for investigation. In this section on ramifications net income, retained income, and items relating to both shall be discussed.

Liabilities, assets, and the proprietors section in the balance sheet are topics that will receive attention from both points of view. The emphasis will be placed on the entity concept. A chart has been provided comparing the two theories and the main distinctions are displayed there.¹ Thus the internal differences of these broad classes will be the aim of our investigation.

Since the corporation has been visualized as having perpetual life it is evident that the earning of income is more important than the stating of the value of assets on a particular date. This paper shall, therefore, begin with the subject of net income in the discussion of the ramifications of the entity theory.

The Entity and Net Income

It has been suggested that either the proprietary or the entity theory of accounting "provides a satisfying explanation of profit if adopted consistently."²

Much disagreement exists today with respect to income expenses, losses, and surplus because of a shifting of viewpoint between the entity and the proprietary theory. Apparently much of this is caused by the attempt to follow the

¹See page 32 of this paper.

²Stephen Gilman, Accounting Concepts of Profit (New York: The Ronald Press Co., 1939), p. 598.

law in respect to accounting for the single proprietorship, partnership, and the corporation. However, the dilemma is certainly not anything new. Gilman³ wrote in 1939,

It is believed that much present day altercation and disagreement with respect to income, costs, expenses, losses, and surplus are traceable to an unconscious swaying between these viewpoints.

Speculating upon the reasons for such a misfortune in the same area was George R. Husband⁴ who wrote,

It is somewhat ironic that the lawyers, who have done more than anyone else to publicize and popularize the entity convention, do not themselves apply it consistently to all forms of proprietorship, nor in fact are they always consistent in applying it to the corporation.

No matter how much disagreement there is among accountants or what the reasons are for that disagreement the fact remains that a net income figure must be arrived at. The problem then is simply one of "how do we get it?" It is at this point that a further complication sets in: the traditional accounting period! Without an accounting period the calculation of profits would be made easy since no real profit could be recognized until the business entity had terminated. This statement is not without support. Kester⁵ said, "Profits are accurately and definitely

³Ibid., p. 598.

⁴George R. Husband, "The Corporate-Entity Fiction and Accounting Theory," The Accounting Review, September, 1938, p. 241.

⁵Roy B. Kester, Advanced Accounting (New York: The Ronald Press Company, 1933), p. 494.

determinable only when a business ceases and is liquidated. Profits of a going concern are always estimates." Canning⁶ repeats this stand from the viewpoint of both accounting and economics while listing four points of which we quote number four: "All measures of income for periods less than the total lapse of time during a relationship or less than the duration of an enterprise are approximate indexes only."

This will lead us to two of our present day conventions; the going concern convention and the accounting period convention, both of which concern the accounting entity and net income. Actually it could be said that the corporate entity is responsible for these conventions because of its perpetual life feature. Since the corporation seems to be the most likely prospect to which the entity theory is applied this paper shall discuss net income in respect to that form of business enterprise.

In June 1936 the Executive Committee of the American Accounting Association issued a "Tentative Statement of Accounting Principles Affecting Corporate Reports." This was followed, in 1941, by a revision entitled, "Accounting Principles Underlying Corporate Financial Statements," and in 1948, by a second revision entitled "Accounting Concepts

⁶Canning, op. cit., pp.123-124.

and Standards Underlying Corporation Financial Statements."⁷

In 1955, the committee was assigned the task of revising the 1948 Statement. In October 1957 the latest revision was published in that month's issue of The Accounting Review. The Association sought to gain consistency in accounting reporting for the corporate form of business. Since this statement was revised and issued in 1957 it is just now coming under attack by accounting authors in articles appearing in The Accounting Review.⁸ The attempt to issue this form of statement is nevertheless an aid to the adoption of a consistent method of accounting for net income. The only thing that is now lacking is an attempt to adopt either the entity or the proprietary point of view. Until the committee does this there will be no agreement and criticisms will continue to appear.

The entity concept views the net income of any form of business as an increase in the liability (non-legal) that the entity owes to the corporate stockholders.

⁷Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements 1957 Revision," The Accounting Review, XXXII (October, 1957), 540.

⁸See George J. Staibus, "Comments on 'Accounting and Reporting Standards for Corporate Financial Statement--1957 Revision'," The Accounting Review, XXXIII (January, 1958), 11; Arthur C. Kelley, "Comments on the 1957 Revision of Corporate Accounting and Reporting Standards," The Accounting Review, XXXIII (April, 1958), 214; and Eldon S. Hendriksen, "The Treatment of Income Taxes by the 1957 AAA Statement," The Accounting Review, XXXIII (April, 1958), 216.

Perhaps it might be better to say that the entity, as an entity does not make either a profit or a loss. This should help clear the path for accountants by eliminating the necessity for arguing that corporate income and stockholder income are, or are not the same.

The opposite viewpoint is taken in the 1957 revision of Corporate Standard of Reporting as stated by the Committee on Concepts and Standards. They seem to view the entity as making an income of its own by stating,

The realized net income of an enterprise measures its effectiveness as an operating unit and is the change in its net assets arising out of (a) the excess or deficiency of revenue compared with related expired cost and (b) other gains or losses to the enterprise from sales, exchanges, or other conversions of assets. Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income.

In determining net income to shareholders, however, interest charges, income taxes, profit-sharing distributions, and credits or charges arising from such events as forgiveness of indebtedness and contributions are properly included.⁹

Since the term "net income to shareholders" is used to describe the increase of indebtedness owed by the entity to the stockholder we will for the purpose of this paper recognize the use of the term as suggested by the Committee. The view as stated constitutes a definite shifting of viewpoint between the entity and proprietary theories.

Actually there is much disagreement as to the words "income," "earnings," "revenue," "profits," and "gains."

⁹Committee on Accounting Concepts and Standards, op. cit., p. 540.

It is believed that W. A. Paton's concept of revenue is the one which has the outstanding merit of common acceptance.¹⁰

Paton says,

The most conservative criterion of income is the receipt of cash. Cash--meaning thereby any generally recognized medium of exchange--can be used to purchase any desired commodity or service whatsoever, provided the same is available on the market, to retire obligations, to pay taxes, to pay dividends, to liquidate terminable proprietary investment, etc. Cash is the asset excellent. The receipt of cash for product, consequently, furnishes the ultimate test of revenue realization. From this standpoint the cash sale and the collection of cash following the so-called credit sale constitute the principal income transactions, the important occasions for entries in the revenue account.¹¹

This concept indicated the desirability of applying the word "income" to gross sales less appropriate deductions therefrom. In another work Paton says,

Net business income or net revenue may be defined as the amount by which the equities of the proprietors and all others entitled to participate in income are enhanced as a result of successful operation.¹²

A vivid description of net income is given by A. C. Littleton quoted from an early issue of the Harvard Business Review. He says,

Net income then is shaped, as it were, by the interaction of the blades of a pair of shears--revenue as one, cost as the other. It is obvious that both blades are necessary to produce the result, but their

¹⁰Gilman, op. cit., p. 605.

¹¹Paton, Accounting Theory, op. cit., p. 444.

¹²Paton, Essentials of Accounting, op. cit., p. 82.

action is not necessarily equal. One blade may rest passively on the table while the other blade moves actively up and down under the power of the operator's fingers. The passive blade represents revenue--the element under little direct managerial control; the active blade represents costs--the element under considerable managerial control in the process of producing net income.¹³

In the various explanations, certain elements are usually present. Foremost is the general insistence that income should be realized before it properly can be recognized by the accountant. With few exceptions, it should be the result of completed transactions with outsiders.¹⁴

From the standpoint of the Income Statement the following items are the point of most controversy between the two theories of accounting.

1. The source of profits.
2. The definition of expenses, costs, and losses.
3. Depreciation taken.
4. The distinction between operating and non-operating items.

The following paragraphs shall attempt to explain these items from the entity concept.

The source of profits. The entity views profits as coming from operating revenue only. A distinction is made between those increments which are the result of

¹³A. C. Littleton, "Business Profits as a Legal Basis for Dividends," Harvard Business Review, XVI, No. 1 (1937), 58.

¹⁴Gilman, op. cit., p. 608.

extraordinary transactions.

Normally the accountant has three alternatives when he is confronted with an item of revenue. He may credit it to the sales account, other income, or directly to the retained income account. The first question is whether the increment of income is applicable to the current accounting period. If it is applicable then the decision is whether to credit it to Sales or Other Income. The second question is whether the item falls in one of the following categories:

1. Operating recurring losses or gains
2. Operating non-recurring losses or gains
3. Non-operating recurring losses or gains
4. Non-operating non-recurring losses or gains

If it is decided that any item of income or expense falls in one of these categories then it will be properly included in this period's profit and loss computation. But if it is decided that the item should not be shown as a loss or gain of the current period, it has been customary to debit or credit it directly to the retained income. Logically this is an excellent method of correcting errors of prior periods. It fits the entity concept and the mechanics of bookkeeping to perfection. The unfortunate result is its effect on the Retained Income Account based on the view taken of Retained Income by the accountant. This topic does not concern the computation of profit or net income, however, and will be explored later in this paper.

Suffice it to say at this point that the procedure just outlined for determination of items to be included in the computation of net income is based on the concept of the accounting entity. The only prerequisite at this point is that the item must be an operating increment based upon the skillful operations of the corporation during the current accounting period.

The definition of expenses, costs, and losses. Another point of controversy is the problem of distinguishing between expenses, losses, and costs. In the 1957 revision of Standards for Reporting on Corporate Financial Statements the Committee on Concepts and Standards separated expenses from losses and vice versa thus providing for a clear understanding and definition of expense and loss. The new separation would be outlined as follows:

A. Expired costs

1. Expenses
2. Losses

Expired costs are defined as those costs which will benefit no future period. Expenses are looked upon as being recurring operating costs which enhance the revenue stream. Losses are non-recurring cost which do not enhance the revenue stream. The only word which remains undefined is the word "cost."

Unfortunately definitions of the word cost are as various as there are accountants to think them up. For the

purposes of this discussion a definition provided by Paton and Littleton will be used. "Broadly defined, cost is the amount of bargained-price of goods or services received or of securities issued in transactions between independent parties."¹⁵ Expired costs then fall in line to represent those costs which are assigned to this period's revenue and the remaining assets represent the remaining costs. This unfortunately would be criticised on the basis that cash could never be a cost, however, if we approach the view from the entity concept this does not seem so impossible. The entity could receive cash only by exchanging an asset for it or by incurring a liability and since it must account to its proprietors for any increase in assets, cash could be considered a cost waiting to be expired.

Depreciation taken. The basic concept of depreciation from the entity point of view visualizes depreciation as a cost-spreading technique which is essential in the determination of periodic reported net income. The proprietary concept since it places emphasis upon the balance sheet attempts to relate depreciation to the net worth of the proprietor.

There is some conflict between two viewpoints if the depreciation taken is thought of in any other terms than

¹⁵Paton and Littleton, An Introduction to Corporate Accounting Standards, op. cit., p. 24.

historical-cost-of-depreciated-assets dollars. The latter definition is held by only a comparatively few proprietary theorists.¹⁶ The entity view maintains that the cost of the asset be spread over the number of accounting periods that the asset is expected to service. This method is logical from the standpoint of the entity theory since it is of no concern to the entity where its capital is obtained.

The distinction between operating and non-operating items. A considerable amount of literature is available on operating and non-operating gains and losses. The point of greatest controversy among accountants and a number of lay groups including the government, is whether to include both in the income statement. In the entity theory the road is very clear. There should be no such argument. All items which are the result of skillful operation of the business should appear on the income statement. All items which do not reflect the skillful action of corporate management should not appear.

This would suggest that any operating item would appear as a matter of necessity since the current operation of the business is involved. The non-operating item would appear on the income statement only if it concerned the action of management and would appear elsewhere if it was an unusual item which did not reflect management's current

¹⁶Newlove and Garner, op. cit., p. 25.

operating results. The only problem that exists here is the determination between that which is usual and that which is unusual.¹⁷

The entity's view of income to the stockholders. In the earliest discussion of the slave approach to understanding the entity in relation to the stockholders it was said that the slave "accounts" to the proprietors for every increase and decrease in the assets of the business. Accountants have generally followed this approach in their thinking about the entity. The question which arises is again one of viewpoint. How does the accountant view income earned by the entity? Is it to be considered capital or is it to be considered income held for the stockholders?

The following quote from G. R. Husband seems to state the present thinking of accountants:

Paton and Littleton state the earnings of the enterprise constitute earnings to the stockholders at the moment of their realization. Earnings retained in the business out of such income are thus part of the stockholders' capital investment. No dividend--cash or stock--is therefore interpreted as income: cash dividends are merely a withdrawal of capital from the business; stock dividends are merely formal notice that previous income which was capitalized is converted to stock form.

He continues, commenting upon the accountant's position with respect to these views by saying,

It is to be noted that as a general matter the accountant treats cash dividends in a manner consistent

¹⁷Ibid., p. 432.

with the separate entity theory. The treatment which is generally accorded stock dividends, on the other hand, is more in line with the aggregation of individuals point of view.¹⁸

The entity looks upon its stockholders as creditors, therefore, accounting should reflect this point of view in its reporting for the entity. This will mean that all distribution of entity income is a distribution of capital to the shareholder.

In order to be absolutely consistent the accountant must then consider either a cash dividend or a stock dividend as being a distribution of capital to the entity shareholder. This position is not now accepted by the profession although it has been suggested many times. G. R. Husband, in the work just cited, echoed this opinion saying,

A distribution of assets which reduces the corporate entity's equity in itself (a cash dividend) or the transferring of part of the corporate entity's equity in itself to the stockholders (a stock dividend) transfers to the stockholders something which was not theirs previously and therefore constitutes income to the stockholders.¹⁹

From the pure entity theory any distribution to the shareholder should be treated as a distribution of capital. The logic of this rule in entity theory is well seated.

The net income of the entity carried to retained income.
The area which lies between (1) net profit before other income and charges, and (2) net profit for the period carried to

¹⁸Husband, op. cit., p. 555. ¹⁹Ibid.

retained income, has clearly been noted as a perennial battleground of accounting. Disagreement as to what kinds of items should or should not be included there-in results from certain divergent viewpoints which may never be reconciled.²⁰

This statement appeared in an accounting book written almost twenty years ago. The prediction that this statement made is still valid today. While criticizing The 1957 Revision of Corporate Accounting and Reporting Standards, Arthur C. Kelley says,²¹

. . . there is one conclusion that is most surprising and disappointing, and could only cause confusion in the minds of the readers of corporate accounting statements. This is the statement with regard to Part IV, Income Determination, as follows: "Interest charges, income taxes, and true profit sharing distributions are not determinants of enterprise net income."

He continues,

Even if this distinction were logical, which is not the case, what on earth would be the usefulness to the readers of financial statements?

The thinking of accountants seems to be divided between two views. There are those who favor surplus entries for certain losses, gains, or adjustments which the other group considers to be essential elements in the computation of net profit.

²⁰Gilman, op. cit., p. 584.

²¹Kelley, op. cit., p. 214.

The two most common items located between the entity's net income and the Retained Income Account are interest and income taxes. It is difficult to establish exactly how the entity should view these items. Should they be considered expenses of the entity or should they be simply reductions of the entity's liability to its proprietors? According to the Committee on Concepts and Standards of the American Accounting Association these items should be excluded from the determination of the enterprise net income but included in the determination of stockholder income. Apparently the Committee has taken the stand that interest and income taxes are not expenses to the entity.

Income taxes. Arguments against the inclusion of income taxes in the expense category and in favor of treating them as distributions of income can be classified as one of three types: (1) it is argued that income taxes are not like other expenses as they are not payable if there is no income and no measurable amount of goods and services are received and consumed in the realization of income, (2) it is argued that the government is a "partner" or "beneficiary" with special interests in the business, and (3) the assumption is made that the incidence of the tax is on the stockholders and therefore it is a kind of withholding tax paid to the government for the stockholders?²²

²² Hendriksen, op. cit., p. 217.

Authors have held for some time that there is no such device as double taxation in the corporate form of business. The entity is taxed as a separate person. Naturally, the proprietary theorists hold to the contrary. Whether there is a double tax or not appears to simply be a matter of viewpoint. In defense of the entity concept of taxes we cite G. R. Husband who says, "It is a commonplace that amounts which private individuals pay out of their income to other individuals are taxable to both."²³ Commenting on the proprietary view of taxes Husband states,

Profit in the long run can fall neither below the minimum nor rise above the maximum necessary to attract capital in given risk situations. "Normal Profits" will prevail. It must be believed that corporate shareholders, will be influenced by profits after taxes. Thus the corporation will collect its taxes paid by increasing the price or paying lower wages.

From this point of view the corporation acts only as a collection agency and to this extent even from the association of individuals view there is no double taxation existing.²⁴

Since no double taxation seems to exist it is certainly logical to say that the income tax levied against a corporation is definitely an expense and, therefore, should be included as a deduction to arrive at net income before the "other charges" section of the income statement. In arguing against treatment of income taxes as a profit

²³Husband, op. cit., p. 555.

²⁴Ibid., p. 556.

distribution Robert Sprouse says,

In measuring the income of a corporation, income taxes must be deducted. The state and federal governments are not corporate investors. Accordingly, the number of dollars which could be distributed to corporate equityholders without impairing their cumulative investment is clearly adversely affected by the imposition of income taxes.²⁵

W. A. Paton supports the same view by stating,

Taxes are a somewhat anomalous element in business finance. Taxes are coerced; their amount is largely outside the control of management; they do not follow price trends closely; they can hardly be said to measure the value of services received and utilized in production. Taxes, therefore, are not strictly congruous with ordinary expenses. However, taxes are clearly a deduction from or charge against revenues in the process of determining net income.²⁶

Both of these views reflect proprietary thinking even though they are made under the disguise of accounting for the corporate entity. The one statement that seems to refute their arguments is that "if there are no profits there are no income taxes." Therefore, income taxes as viewed by the entity must be a distribution of profits and, therefore, deductible after net income and not in arriving at it.

It cannot be decided here which of the viewpoints will prevail. The Committee on Concepts and Standards has taken the lead and it will take time to decide whether accountants will accept the Committee's decision in order

²⁵Robert T. Sprouse, "The Significance of the Concept of the Corporation in Accounting Analysis," The Accounting Review, XXXII (July, 1957), 372.

²⁶Paton, Essentials of Accounting, op. cit., p. 99.

to provide more consistent accounting financial statements. It should be added that this expression is in no way defending the committee's position concerning accounting theory. The writer will agree that the present tentative standards for corporate reporting is a regression instead of a step forward, however, it is also well established that consistency is more important than error. Consequently for the sake of consistency the profession of accounting might do itself a service if the statement could be adopted until it can be improved. Most of the concepts contained in the statement are agreeable to accountants, therefore, in the best interests of the profession the controversial areas should be temporarily set aside. As soon as consistency is then obtained the arguments may continue. This would provide the profession with a statement to correct. Presently, there is no such statement universally and consistently applied and, therefore, no such statement to correct.

Interest charges. The other item which usually appears between the income statement and the surplus statement is interest expense. (Interest income also appears but there seems to be little controversy regarding this method of classification.) It is probable that the majority of accountants consider interest payments as an item of non-operating expense and would in the classification of the income statement include it under the caption of "Other

Charges." The Executive Committee of the American Accounting Association has disagreed saying,²⁷ "the amount of interest incurred on borrowed money, including debt discount and expense properly amortized during the year" should be included in the operations section of the income statement. However, the Committee on Concepts and Standards of the American Accounting Association recently states that interest charges are not to be recognized as expired costs and would now seem to refute this former stand taken by the Association.²⁸

Sanders, Hatfield, and Moore mention the matter of interest under the general heading of "non-operating section" in the following words:

It is desirable to show the division of earnings of the business as an economic enterprise between those who furnish capital on loan at fixed interest rates and the stockholders who take the residuary gain or loss. Interest will thus be a separate charge against earnings.²⁹

W. A. Paton states,

Interest charges--a return on creditor capital should be treated as a contractual distribution of income rather than as operating expense. Otherwise the fact

²⁷Executive Committee of the American Accounting Association, "A Tentative Statement of Accounting Principles Affecting Corporate Reporting," The Accounting Review, XI (June, 1936), 189.

²⁸Committee on Concepts and Standards, op. cit., p. 540.

²⁹T. H. Sanders, H. R. Hatfield, and V. A. Moore, A Statement of Accounting Principles (New York: American Institute of Accountants, 1938), p. 38.

of the concern's earning power as an economical entity, aside from specific capital structure, is obscured, and comparisons between different enterprises and between periods in the same enterprise tend to be improperly made.³⁰

Arthur C. Kelley taking the opposite viewpoint says,

Interest charges likewise are costs of borrowing funds needed by the enterprise and it is hard to see any useful purpose accomplished by considering interest charges as distribution of income to the creditors, as some economists view them, instead of as cost in determining net income, which is the universal business concept.³¹

Roy B. Kester agrees with Paton that for purposes of intercompany comparisons interest should be treated as a distribution of profits but from the strictly theoretical standpoint he believes that, "these items [interest income and expense, cash discount items, bad debts, collection losses, et cetera] are as much elements of normal operation as the selling and administrative item."³²

The classic argument against considering interest as a distribution of income finds its support in the lack of profits that the entity may experience. The question arises as to what is the nature of interest payments made to bondholders during a period of no income? If there is an earned

³⁰W. A. Paton, Advanced Accounting (New York: The Macmillan Company, 1941), p. 22.

³¹Kelley, op. cit., p. 215.

³²Kester, op. cit., p. 73.

surplus then it is possible to consider interest as being a distribution of prior period's income. But what if there is no retained income? Commenting upon this possible situation R. T. Sprouse mentions, "It cannot be a return of the bondholders' investment because their investment equity is not reduced by these payments; it is the investment of the common shareholders which is diminished."³³

Also an advocate of the deduction of interest in determining net income Sprouse defends his position by saying,

Interest charges represent a valid economic cost of the use of the capital supplied by bondholders to the incorporated social institution. In determining the dollar amount which could have been distributed to society, perhaps in the form of lower prices or improved product, without impairing the cumulative number of dollars invested in the corporate institution, interest charges must be deducted on an equal footing with wages and rents.³⁴

Clearly from the entity's point of view, since we have defined it as being an entity separate and distinct, it should consider interest charges as payments to capital providers and thus payable out of any income that is produced as a result of the entity's capital and not as a charge necessary to earn that profit or income.

However, from the viewpoint of the accountant this whole area between the income statement and earned surplus or retained earnings seems to depend entirely upon the definition of cost.

³³Sprouse, op. cit., p. 373.

³⁴Ibid.

If cost is defined as cost to the stockholders (or the proprietary theory) then these items should be considered as deductions in arriving at net income. If cost is defined as cost to the business (or the entity theory) then these items should be considered as distributions of income. From the entity viewpoint it is assumed that there are three factors of all production: resources, labor, and capital. It might seem strange that only capital is considered to receive a distribution of income. However, wages paid to labor or prices paid for resources are considered costs in producing income and not distribution of income. This treatment is given to wages and rents because the entity is interested in accountability to its capital providers. This, of course, has the unfortunate ring of requiring two different definitions of the term "cost."

The Entity and the Valuation of Assets

Current assets. Current assets have been defined as those assets which will expire within one accounting period. Consequently neither the entity or the proprietary theorist have much difficulty in establishing a value for these classifications. Most generally the current asset fairly represents the current market price because of its relatively short life. The main complication is the valuing of inventory, receivables, or marketable securities; items which could conceivably distort the balance sheet if the entity was in a period of rapidly rising or falling prices.

Normally very little difficulty is encountered valuing current assets and consequently we shall spend very little time exploring the area. Any current asset reflected in the profit and loss statement, or income statement if you prefer, as an expired cost will be wholly eliminated in this accounting period and, therefore, it is expected that either the entity or the proprietary theorist would agree that the valuation of this classification would closely represent the current market value of the particular asset.

Fixed assets. In business entities, as contrasted with some governmental or charitable institutions, the cost of fixed assets must be allocated to those accounting periods benefiting from their use. This view has been expressed by eminent authorities so often that it is not necessary to support it at any great length. Perry Mason, whose Principles of Public-Utility Depreciation is generally recognized as authoritative, says:

The asset account may well be thought of as a deferred charge to operations or a prepaid operating expense, similar in a great many respects to prepaid rent or insurance--charged to the operations of the period in which the service is rendered.

Sanders, Hatfield, and Moore assert that fixed assets,

³⁵Perry Mason, Principles of Public-Utility Depreciation (Chicago: American Accounting Association, 1937), p. 13.

"are really in the nature of a deferred charge against the future income they will help to produce."³⁶

The concept of fixed asset cost as equivalent to a deferred charge is helpful in that it tends to simplify problems of valuation. Obviously, no theoretical advantage can be gained by valuing a deferred charge at any other figure than actual cost, if such a cost is obtainable.

Attempts have been made to exclude land from this deferred charge concept. It is commonly held that land does not depreciate. Generally this is true, however, in the best interest of consistency it is well to think of land as representing a deferred charge over an indeterminate or perpetual term. It is true that land is ordinarily not subject to wear and tear or that type of depreciation which results solely from the passage of time.

The convention that fixed asset value is in the nature of a deferred charge, and that such a deferred charge should be established at cost whenever cost practically can be determined, represents the simple theory underlying valuation and depreciation by the business entity.

In practice this reasonably simple concept can be greatly modified by various complicating factors. Important problems of fixed asset valuation arise when purchases are made with securities, when one asset is exchanged for

³⁶Sanders, Hatfield, and Moore, op. cit., p. 59.

another asset, when assets must be reconstructed or renovated, or when fixed assets are donated.

When fixed assets are acquired in exchange for the purchaser's own securities, the initial value of such assets is measured by the offsetting liability created by the issuance of such securities. From the entity viewpoint, no other basis of fixed asset valuation is logical despite the fact that the property for which a million dollars par value of common stock is exchanged could have been bought for \$500,000.00 cash. Such knowledge has upset those accountants who have placed great emphasis upon the balance sheet values. To the entity, however, the creation of a million dollars in liabilities, even though it is a capital stock liability, is equivalent for record purposes to the disbursement of a million dollars in cash. The million dollar valuation of the fixed asset is not only logical but, from the standpoint of the entity, imperative. The fact that the practical conservative accountant would disagree violently with this concept is, of course, important from all points of view except that of developing a logical pattern of accounting theory.

The exchange of one asset for another involves a problem which is substantially the same as the valuation problem of trade-ins so often noted in the purchase of office equipment, automobiles, or household devices.

From the income tax viewpoint, subject to certain exceptions, no profit or loss arises from exchanges of

like for like.³⁷ From the accounting point of view, authorities are not in agreement. The Accountants' Handbook mentions the following:

An exchange of a farm for an apartment building, for example, is equivalent to the sale of a farm and the purchase of the city property with the proceeds. From a commercial point of view the book value of the farm in such case should be closed out and the fair market value of the other property [what it would have cost on a cash or equivalent basis] substituted, the difference being gain or loss.³⁸

Roy B. Kester takes the opposite point of view stating that, "the trading of a fixed asset for another fixed asset is not ordinarily to be considered a profit-making exchange."³⁹ He explains the common practice of applying the "profit" resulting from an exchange as a credit against the newly acquired fixed asset on the theory that the item is of the nature of a "discount from the stated price." He adds, however, that if a newly acquired fixed asset has a definite list price or if the price would not have been lower on a cash or other outright purchase basis, an accounting profit has been made. Illustrating this point by the exchange of an old truck for a new one, the profit, he asserts,

³⁷Prentice-Hall, Federal Income Tax Course (New York: Prentice-Hall, Inc, 1957), p. 1401.

³⁸Accountants' Handbook (New York: The Ronald Press Company, 1934), p. 489.

³⁹Kester, op. cit., p. 493.

is explainable either as the result of a good bargain or because the old truck had been depreciated too rapidly, some portion of its reserve account being really a reserve of profits at the time of trade-in.⁴⁰

Problems arise when a fixed asset is partially or entirely constructed by the employees of a company. The actual direct labor and material costs are, of course, transferred to and become a part of the fixed asset valuation. The difficulty of valuation has to do with the allocation of overhead expense to the construction work. The problem of equitable overhead distribution is a difficult one.

Too great a proportion of overhead transferred to the construction work may reduce the balance assignable to regular manufacturing so greatly as to affect manufacturing costs and hence affect inventory values and both gross and net profits. Many authorities content that no overhead expense should be applied to construction work unless there has been an actual increase in the overhead expense due directly to the work.

These authorities would add to such asset accounts only the overhead that can be attributed directly to the work done on the plant or equipment. However, this is the practical approach rather than the theoretical approach. The entity theorist is more concerned with spreading the cost of fixed assets over the number of periods to which

⁴⁰Ibid., p. 335.

that asset contributes its service. The only practical matters which prevent this theoretical approach are the unwillingness of corporation managers to maintain the records necessary to make such an allocation and the recognition that this practice might easily open the door to undetectable schemes of manipulating profit and loss statements.

Occasionally fixed assets are donated to an enterprise. Often such a donation is made by a group of business men seeking to attract new industries to a town. Sometimes the donation is conditional, but if an outright donation is made, it is common practice to have the property appraised, the offsetting credit not being considered a profit but rather as a type of capital surplus. The amount of profit actually made is not determinable and will not be determinable except through depreciation or until the donated property is sold. The valuation established for such donated property is, therefore, only a symbol for record keeping purposes and the credit representing an indeterminate amount of unrealized income is correspondingly a symbol.

Thus it may be said that the valuation established for the entity has a definite significance as a symbol of chargeability and as a deferred charge to future income but otherwise has little or no meaning. The fact that "cost" is used as the basis of accountability should not be strange

in light of our earlier discussion of the entity from the standpoint of the slave. Actually it would be of no concern to the entity if a fixed asset were valued at any price since it simply increases its liability to the equityholders. However, from the standpoint of the entity and the depreciation charge it makes to its income statement, it is more logical to use cost rather than market or replacement values because the increased depreciation charged to income would nullify any apparent advantage gained through increasing the value of the assets. The reason is evident since the entity, because of its perpetual life feature, places more importance upon the income statement than the balance sheet.

The whole question of the valuation of assets through the accounting entity theory is determined by the necessity of recording in accounting periods. The proprietary theorists maintain that it is necessary to increase the value of fixed assets in order to preserve the capital of the proprietor. The entity theorist is not concerned with preserving the capital of its proprietors since he places no emphasis upon any individual capital provider. If he did it would be necessary to increase the individual book-value of each share of stock.

The Entity and the Retained Income Account

Consistency in maintaining the entity viewpoint forbids the use of many convenient terms for expressing the proprietor's accounts in the balance sheet. It is very

difficult to coin a particular phase which will envelope all forms of business enterprise in regard to presenting the proprietor's interest in the business. Many attempts have been made. Such terms as "Net Worth," "Capital Stock and Surplus," "Capital," "Capital and Surplus," "Owner's Equity," "Equities," or "Liabilities and Net Worth," have been used at various times during the long existence of accounting statements.

The law again enters the picture at this stage with its various requirements as to how items, particularly with respect to corporations, shall be shown on financial statements. Through its requirements in the disclosing of capital stock transactions as to par value, paid in surplus, earned surplus, surplus reserves, et cetera, the accountant has encountered much grief. Nevertheless in all of this discussion on terminology, and what term constitutes what, the important issue is usually forgotten. The business entity is primarily concerned with its own retained income account. It is difficult sometimes to realize how any retained income account can exist which has any bearing upon the stockholder. Certainly the earned retained income account has no relation to the stockholder in any fashion if viewed strictly from the entity point of view--except as it reflects the increase in liability to the stockholders.

It is recognized only that a retained income account which reflects income retained for the use of the entity

should exist. This represents the entity's equity in itself.

G. H. Husband voiced this opinion indirectly by stating,

Consistent with the entity theory, it is usually contended that the income of a corporation does not constitute income to its stockholders; yet, when this same income is credited to surplus, it is added to the stockholder's interest as portrayed by the capital-stock account to secure the stockholder's total equity. But how can that which is not the stockholder's equity as income justly become the stockholder's equity as surplus?⁴¹

The fact that the entity is conceived as a unit in and of itself also makes it necessary to decide which items are to be included in the retained income account. Obviously, if an item does not appear in the income statement it must appear somewhere else. The logical answer is the retained income account. However, considerable discussion has revolved around the relation between the income statement, which displays this period's earnings, and the retained income account, which displays the amounts of prior periods' earnings retained in the business. The greatest disagreement comes into focus when the earnings of prior periods must be corrected.

Basically this is merely an extension of the proprietary and entity viewpoints. The proprietary theorists would be those in favor of carrying the adjustments to this period's income statement, while the entity theorists would insist upon leaving the income statement for a reflection of current operating income.

⁴¹Husband, "The Entity Concept in Accounting," op. cit., p. 555.

The argument seems to be one against deception. The entity would favor making these adjustments to retained income as is previously stated. If we take an example it is clear why some authors have considered this method deceptive. Assume that a corporation has sales for three years at the \$50,000.00 level and expenses for these same period of \$40,000.00. In the third year a fixed asset is sold at a \$6,000.00 loss. This loss would be divided into two amounts, \$2,000.00 would appear in the income statement of the third period, while \$4,000.00 would be debited directly to retained income. After this adjustment the income statements of the three years would appear as follows:

CORPORATION X			
	<u>1st Year</u>	<u>2nd Year</u>	<u>3rd Year</u>
Net sales	\$50,000.00	\$50,000.00	\$50,000.00
Expired costs	<u>40,000.00</u>	<u>40,000.00</u>	<u>42,000.00</u>
Net Income for the Periods	<u>\$10,000.00</u>	<u>\$10,000.00</u>	<u>\$ 8,000.00</u>

Assuming that there were no dividends paid nor any other entries to retained income, the balance of the retained income account at the end of the third year will be \$24,000.00 while the aggregate of the reported annual profits is \$28,000.00. This, it is claimed, is deceptive.

The proprietary theorists would include the \$6,000.00 loss in the third period as a deduction from the income statement of the third period. Using the same example the income statement would appear as follows:

CORPORATION Y

	1st Year	2nd Year	3rd Year
Net sales	\$50,000.00	\$50,000.00	\$50,000.00
Expired costs	<u>40,000.00</u>	<u>40,000.00</u>	<u>46,000.00</u>
Net Profit for Period	<u>\$10,000.00</u>	<u>\$10,000.00</u>	<u>\$ 4,000.00</u>

At the end of the third year the retained income of the company will agree with the aggregate of the reported annual profits.

This entire argument has been resolved by suggesting that the income statements for the three years be recast. The objection to this method is that the income statements of the first two years are closed and done with and it is a question as to the usefulness of recasting the statements, especially if one considers the expense of determining an allocation against each of the prior periods affected.⁴² The question seems to now be one of materiality and this is exactly where the issue stands today.

The problem remains as to which method is more nearly correct from the entity point of view. The writer's opinion is that since the income statement is a device for matching current cost and current revenue that the entity would exclude those unusual items which would distort the current operating method. However, it is an established fact that most income statements contain both an operating and non-

⁴²Victor H. Stempf, "A Critique of the Tentative Statement of Accounting Principles," The Accounting Review, XIII (March, 1938), 60.

operating section. This is certainly not the purpose of the entity concept. The non-operating item is properly recognized by entity theory as being a deduction from the liability owed to the proprietors. If the income statement has a separate section devoted to the disclosure of the increase of indebtedness to the proprietors then there is no objection to this procedure. The only objection from the standpoint of the entity is that the resulting figure after the non-operating section cannot be labeled as "net income" because it contains items which were not due to operations. Beyond this there should be no objection theoretically since it is merely a method of disclosing information.

The Entity and Dealings in Its Own Stock

Interesting and controversial accounting problems arise when a corporation deals in its own stock .

Generally a corporation legally cannot purchase its own shares of stock if it does not have a retained income. The reason generally given is that the retirement of one or more stockholder's investment would be to the neglect of the creditors who rely upon a certain amount of permanent capital. Consequently a fiction developed in the accounting world that a reacquired share of stock, or treasury stock, is a deduction from earned surplus. This is, of course, not true from an accounting standpoint--certainly not from the entity standpoint.

Considering the problem strictly from the entity viewpoint an interesting line of argument results.

The entity convention does not distinguish between the liability of an entity for borrowings and the liability of an entity for proprietorship investment. Both are liabilities. Accordingly, one method of exploring this problem is to assume the existence of a sole proprietorship which borrows \$1,000.00 from each of three persons.

The liability side of the entity balance sheet might, therefore, appear somewhat as follows:

Owed to James Brown.	\$1,000.00
Owed to Al Petersen.	\$1,000.00
Owed to Jack Cory	\$1,000.00
Owed to Proprietor Jim Delaney . .	\$5,000.00
Total liabilities	<u>\$8,000.00</u>

In this illustration it is assumed that Jim Delaney is the proprietor. If the indebtedness to Brown, Petersen, and Cory is evidenced by three ten-year promissory notes bearing an interest rate of six per cent, then the entity will owe each of these creditors \$60.00 a year for interest and at the end of a ten-year period will owe each of them \$1,000.00.

Immediately after making his loan James Brown changes his mind and sells his note to the entity for \$1,000.00. Instead of cancelling the note the entity resells it to Ron Patten for \$1,100.00. At the time the money is received from Ron Patten, \$1,000.00 of it is recorded as a liability to him, while \$100.00 of it is treated as a deferred credit

to be amortized against interest expense. In other words, from the entity point of view it is a deferred credit to the proprietor's account, and offset to the interest expense which will be debited annually to the proprietor's account. Such a premium is, of course, common in connection with bond issues but there is no reason for not using a similar account in connection with a note issue. The entity must pay Ron Patten \$60.00 a year interest, which is credited to Cash and debited to Expense. Each year \$10.00 must be transferred to Interest Expense from Premium on Notes Payable.

If it is assumed that these notes mature in one hundred years instead of in ten years, the same original entries will be made but instead of amortizing the premium at \$10.00 a year, it will be amortized at \$1.00 a year. If the maturity of the notes is one thousand years instead of one hundred years, then the premium on noted payable will be amortized at the rate of ten cents per year. If the liability represented by this note is perpetual, then the premium on notes payable will never be amortized but will continue to stand as a perpetually deferred credit to the proprietor's account.

According to the entity convention the proprietor's investment is a liability of the entity. Accordingly, the investment by the stockholders in a corporation must be considered a liability of the entity to those stockholders

regardless of legal contradictions. The illustration, therefore, may be changed to show James Brown, Al Petersen, Jack Cory, each investing \$1,000.00 in the corporation, a \$5,000.000 interest in which is owned by Jim Delaney, the four of them being the only stockholders. Disregarding the legal prohibitions, assume that James Brown sells his stock certificate to the entity for \$1,000.00. This stock certificate then represents treasury stock and is resold to Ron Patten for \$1,100.00. Of this \$1,100.00, \$1,000.00 represents a liability of the entity to Ron Patten. \$100.00 may be considered a premium on capital stock, also a liability. This \$100.00 credit item may be considered as a deferred credit applicable against dividends, but since the liability represented by the capital stock is a perpetual liability, this deferred credit item of \$100.00 will stand forever on the accounting records and will not be amortized against Ron Patten's dividends.

This particular analogy appears to have some analytical value to those who, having once adopted the entity convention, are prepared to use it in any kind of an accounting problem. This analogy and argument logically suggest that the "profit" resulting from the sale of treasury stock at an amount greater than its cost to the entity is in the nature of a perpetually deferred credit to income and hence to proprietorship, and is not an item of income which will ever come into being until the termination of

the corporation itself. Christening such a perpetually deferred credit as "capital surplus" is merely a matter of terminology and its inclusion under that title as one of the proprietorship items seems entirely logical and correct.

Based upon different reasoning the majority of authorities seem to have come to the same conclusion.

Raymond Marple says: "Where treasury shares are reissued for more than cost to the corporation, there arises an element of capital surplus."⁴³

The Committee on Definition of Earned Surplus of the American Institute of Accountants says that: "Capital surplus comprises paid-in surplus and revaluation surplus." In describing items properly to be included in paid-in surplus, the committee mentions "profits on resales of treasury stock."⁴⁴

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants (name changed only recently) in Bulletin 43, said,

Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset

⁴³Raymond P. Marple, Capital Surplus and Corporate Net Worth (New York: The Ronald Press Company, 1936), p. 74.

⁴⁴Accounting Terminology (New York: American Institute Publishing Company, Inc., 1931), p. 119.

value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.⁴⁵

Thus it may be supposed that the majority of opinion seems to favor the entity theory in dealings of the corporate entity in its own stock.

The Entity and Financial Statements

The various classifications of accounts under the entity concept are clearly illustrated in its financial statements. A reflection upon the thinking of those people preparing the financial statements for the entity are readily discernible when one views the reports produced by the entity.

- As has been stated many times in this paper the income statement is, from the standpoint of the entity, probably the most important statement. We shall consider it first.

There have been two age old arguments concerning the presentation of an income statement. One group (mainly proprietary theorists) holds that the income statement should be all inclusive. The other group (mainly entity theorists) hold that the income statement should reflect

⁴⁵Committee on Accounting Procedure, Restatement and Revision Accounting Research Bulletins (New York: American Institute of Accounts, 1953), p. 14.

only the "current operating performance" of the business. During recent years one of the most debated subjects concerning classification has been that revolving around the question of the proper treatment of extraordinary gains or losses recognized during the period. The proprietary theorists favor the all-inclusive income statement and advocate the inclusion in the income statement of all items of profit or loss recognized during the period whether or not they are related to that period's operations. The entity theorists, on the other hand, favor the current operating performance type of income statement and maintain that the income statement should include items which contributed to ordinary operations for the period covered, and should exclude extraordinary items of material amount which are not related to operations for the period.

The Committee on Accounting Procedure of the American Institute of Accountants stated in 1947 in Accounting Research Bulletin 32, and repeated in 1953 that,

. . . there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. . . . Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not

of the type in which the company generally deals;

(c) Material losses of a type not usually insured against such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a current hazard of the business;

(d) The write-off of a material amount of intangibles;

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of a debt before maturity.⁴⁶

In a later section the committee expressed a strong preference for reflecting these items in the surplus statement rather than the income statement. This would seem to support the entity concept of income. However, in view of the revised Regulation S-X issued by the Securities and Exchange Commission in December, 1950, which required that these extraordinary items be reflected on the income statement as an addition to, or deduction from, net income or loss, the Committee also considered the all-inclusive income statement as acceptable providing care is taken that the figure of net income is clearly and unequivocally designaged so as not to be confused with the final figure in the income statement.⁴⁷

Under the procedure recommended by the Institute (or entity concept), the surplus statement, or "statement of retained income," as it is moreoften called, might contain the following items:

⁴⁶Ibid., p. 63.

⁴⁷Ibid., p. 64.

BALANCE AT THE BEGINNING OF THE YEAR	\$5,000,000.00
ADDITIONS:	
Net income for the year, from income statement	200,000.00
Total	<u>\$5,200,000.00</u>
DEDUCTIONS:	
Dividends on common stock	300,000.00
Loss on sale of land and buildings	75,000.00
Loss on retirement of bonds before maturity	60,000.00
Transfer to Reserve for future decline of inventory prices	100,000.00
Total Deductions	<u>535,000.00</u>
BALANCE AT END OF THE YEAR	<u><u>\$4,665,000.00</u></u>

The statement above includes two extraordinary items of material amount, the loss on the sale of land and buildings, and the loss on retirement of bonds. The current operating performance type of income statement would not include these two items; instead they would be shown in the retained income statement, as illustrated above.

The requirement of the Securities and Exchange Commission arising out of the December 1950 revision of Regulation S-X, although now acceptable, still does not represent the type of presentation preferred by the Institute or the entity theory. It should be pointed out, however, that there is no disagreement concerning certain items customarily shown in the retained income statement. Both agree that dividends, appropriations to retained income reserves and reductions of retained income reserves should be properly shown in the retained income statement. Reserves for retirement of preferred stock, reserves for contingencies, reserves for future decline of inventory prices, reserves for plant

expansion, reserves for replacement of fixed assets at higher price levels, and redemption of bonds are examples of reserves which are generally accepted as being retained income reserves by both the entity and proprietary concepts.

Under the classification suggestion by the Securities and Exchange Commission (and the proprietary concept) the two extraordinary items shown in the preceding illustration would be excluded from the retained income statement, leaving the items shown in the illustration below:

BALANCE AT BEGINNING OF THE YEAR	\$5,000,000.00
ADDITIONS:	
Net income less special items, from the income statement	<u>65,000.00</u>
Total	<u>\$5,065,000.00</u>
DEDUCTIONS:	
Dividends on common stock	\$300,000.00
Transfer to reserve for future decline of inventory prices	<u>100,000.00</u>
Total deductions	<u>400,000.00</u>
BALANCE AT END OF YEAR	<u><u>\$4,665,000.00</u></u>

It is noted here that the reserve for future decline of inventory prices remains in the retained income statement. This is not a (profit or) loss given recognition during the period, but instead is an appropriation of retained income. The two unusual losses would be shown in the income statement, after net income as follows:

NET INCOME FOR THE YEAR	\$200,000.00
SPECIAL ITEMS:	
Loss on sale of land and buildings	\$75,000.00
Loss on retirement of bonds before maturity	<u>60,000.00</u>
	<u>135,000.00</u>
	<u><u>\$ 65,000.00</u></u>

These diverse viewpoints clearly indicate that the disagreement between the entity and proprietary theory still exist and as yet have not been settled. However, there seems to be a growing tendency for acceptance of the inclusion of extraordinary items in a special section of the income statement.

Table II illustrates an income statement which is conceived within the entity theory. Table III, page 81, illustrates the income statement which would not be acceptable to the entity but is very popular from the standpoint of many accountants. It is commonly known as the "all inclusive" income statement. It reflects a considerable amount of proprietary thinking.

The balance sheet. As has been suggested many times previously the income statement is of more concern to the entity theorist than is the balance sheet. However, it must certainly be realized that while this may be true the importance of the balance sheet must not be underemphasized. The income statement accumulates the totals of the expired costs of the entity while the balance sheet is the statement which displays the remaining costs of the entity which carry over to future periods.

The classification of balance sheet accounts in the entity's statement differs very little from that of the proprietary theory. However, it is suggested here that the proprietary theorists do not follow the proprietary equation

TABLE II
 ENTITY THEORY
 STATEMENT OF INCOME
 FOR THE YEAR ENDED DECEMBER 31, 1958

GROSS SALES (less returns & allowances)		\$499,000.00
Less: Cost of Goods Sold		<u>299,000.00</u>
Net Entity Revenue		\$200,000.00
Selling, General, & Administrative Expenses		<u>50,000.00</u>
NET INCOME TO THE ENTITY		\$150,000.00
Non-Entity Revenues:		
Interest Income	\$1,000.00	
Unusual items non-recurring	500.00	
Divident income	<u>500.00</u>	<u>2,000.00</u>
		\$152,000.00
Non-Entity Expenditures:		
Interest Expense	\$2,000.00	
Unusual Items non-recurring	<u>1,500.00</u>	<u>3,500.00</u>
NET INCOME BEFORE INCOME TAXES		\$148,500.00
FEDERAL INCOME TAXES		<u>77,500.00</u>
NET INCOME TO RETAINED INCOME		<u>\$ 71,000.00</u>

TABLE III
PROPRIETARY THEORY
STATEMENT OF INCOME

FOR THE YEAR ENDED DECEMBER 31, 1958

INCOME:

Gross sales less returns & allowances	\$499,000.00
Income from dividends	500.00
Interest Income	1,000.00
Other Income--unusual-recurring and non-recurring	<u>500.00</u>
Total Income	\$501,000.00

EXPENSES:

Cost of Goods Sold	\$299,000.00
Selling Expenses	25,000.00
General & Administrative	25,000.00
Interest Expenses	2,000.00
Other Expenses--unusual recurring & non-recurring	1,500.00
Federal Income Taxes	<u>77,500.00</u>
Total Expenses	\$430,000.00

NET INCOME	<u>\$ 71,000.00</u>
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$A - L = P$. If they do then it is necessary to deduct the liabilities outstanding from the assets of the business in order to arrive at the value of the proprietary account.

The practice of showing net assets and finally listing investments of the stockholders in the form of a vertical statement has been prevalent for a number of years. This would certainly express the proprietary theory even though the general form of the equation is lost.

Strangely enough the most recent change in financial statements seems to fit neither the entity or the proprietary theory of accounting theory. This is the statement which follows the practice of deducting current liabilities from current assets in order to arrive at a figure for working capital.

Examples of these balance sheets appear as Tables IV, V, and VI, on the following pages.

Consolidated financial statements. To date the entity convention offers about the only satisfactory theoretical foundation on which to build multi-company reports. Accountants attempt to treat a group of closely allied corporations as a distinct economic or accounting entity despite the legal lines of separation among the constituent companies.

There are three important aspects of consolidated financial statements: (1) the functions performed by consolidated reports, (2) the circumstances under which they

TABLE IV
THE ENTITY THEORY
BALANCE SHEET
DECEMBER 31, 1958

<u>Assets</u>		<u>Equities</u>	
Current Assets	\$ 500,000.00	Current Liabilities	\$ 200,000.00
Long Term Investments	1,000,000.00	Long Term Debt	3,000,000.00
Fixed Assets	5,000,000.00	Preferred Stock	1,000,000.00
Deferred Charges	10,000.00	Common Stock	2,000,000.00
	<u>10,000.00</u>	Retained Income	<u>310,000.00</u>
	<u>\$6,510,000.00</u>		<u>\$6,510,000.00</u>

This balance sheet of the entity correctly portrays the form of the equation $A = L + P$. It is expected that in order to be consistent the entity theorist would naturally draft such a statement if he wished to explain the assets and equities in their relative positions within the entity theory of accountibility.

TABLE V
 PROPRIETARY THEORY
 BALANCE SHEET
 DECEMBER 31, 1958

NET ASSETS

Current Assets	\$500,000.00
Less Current Liabilities	<u>200,000.00</u>
NET CURRENT ASSETS	300,000.00
Long Term Investments	1,000,000.00
Fixed Assets	5,000,000.00
Deferred Charges	<u>10,000.00</u>
	6,310,000.00
Less Long Term Debt	<u>3,000,000.00</u>
	<u>\$3,310,000.00</u>

INVESTMENTS OF STOCKHOLDERS

Preferred Stock	\$1,000,000.00
Common Stock	2,000,000.00
Retained Income	<u>310,000.00</u>
NET STOCKHOLDER INVESTMENT	<u>\$3,310,000.00</u>

TABLE VI
RECENT MODIFICATION
BALANCE SHEET
DECEMBER 31, 1958

ASSETS

Current Assets	\$ 500,000.00
Less Current Liabilities	<u>200,000.00</u>
NET CURRENT ASSETS	300,000.00
Long Term Investments	1,000,000.00
Fixed Assets	5,000,000.00
Deferred Charges	<u>10,000.00</u>
Total Assets Less Current Liabilities	<u><u>\$6,310,000.00</u></u>

INVESTMENT EQUITIES

Long Term Debt	\$3,000,000.00
Preferred Stock	1,000,000.00
Common Stock	2,000,000.00
Retained Income	<u>310,000.00</u>
Total Investors' Equities	<u><u>\$6,310,000.00</u></u>

should be presented, and (3) the standards and principles which underlie their presentation.

Many unsettled questions concerning the ability of a corporate entity owning or controlling another corporation remain unsettled both at law and in business practice. Because of this a statement concerning the legal or business status of a holding company will not be attempted.

Consolidated statements seem to have gained their impetus in the last half century from Federal Revenue Acts. However, the United States Steel Company, chartered in New Jersey in 1901, presented consolidated statements from its inception. Since then, consolidated financial statements have been a familiar feature of corporate reports.⁴⁸

The presentation of consolidated statements is in order whenever there exists an economic or business entity composed of two or more legal units. Conversely, consolidated statements will not be prepared when an economic entity does not exist.⁴⁹

This statement by Professor Moonitz reflects the general accounting thinking toward the preparation of consolidated statements.

The question which concerns most accountants is, "What constitutes a consolidated accounting entity?" Many suggestions have been offered. Professor Moonitz lists five:⁵⁰

⁴⁸ Maurice Moonitz, The Entity Theory of Consolidated Statements (Brooklyn, New York: The Foundation Press, 1951), p. 7.

⁴⁹ Ibid.

⁵⁰ Ibid., p. 20ff.

1. Percentage of Stock Ownership
2. Controlling Influence
3. Similarity of Operations
4. National Concentration
5. Consistency of Treatment

These five points, although a definite help, have provided no absolute standard for establishing an economic or accounting entity. The accountant must exercise judgment.⁵¹

From the standpoint of the entity theory it is quite possible to conceive of a hybrid entity consisting of many separate entities. Therefore, it is supposed that the same accounting doctrines, conventions, and principles will apply to the consolidated entity.

The leading principle in the technique of preparing consolidated statements is the elimination of all evidences of intercompany relationships. The objective attained by elimination is the rejection of amounts and accounts reflecting transactions among the constituent units and the retention of only those data pertinent to the showing of the affiliation as an economic or business entity. In essence this requires a shift in viewpoint from that of a legal abstraction--the business corporation--to that of an accounting abstraction--the effective business unit.⁵²

⁵¹Ibid., p. 39

⁵²Ibid., p. 84.

It has been the contention of authorities that the entity concept provides a coherent theoretical basis for rationalizing some of the practices already prevalent and competent to solve new problems as they arise.⁵³

Typically the use of these consolidated reports is confined to the use of dominant stockholders, present and prospective, and to the managerial group which wields control. Others may conceivably receive some value from these reports but the exact amount is doubtful.

⁵³Ibid., p. 83.

CHAPTER VI

OTHER VIEWS OF THE ENTITY

Stockholders

In one sense the corporation is a sort of partnership of many people, who put their money into the venture and get back salable interests in it; but the investor does not own the corporation's property, nor is he responsible for its debts. If a person becomes a stockholder he receives "shares" of stock in the corporation, is technically regarded as one of the owners of the business, and is entitled to such dividends, voting rights in selecting management, and other privileges as the law and the corporation's financial progress may make possible.

The typical stockholder is a stranger to the business of his corporation. The very essence of the corporate form of government--like a republic of checks and balance of power--provides for delegation of authority. When authority is left exclusively to others it is to be supposed, from the very nature of things, that the inactive will drift more and more into a lack of knowledge as to what is going on.

Justice Holmes formerly of the United States Supreme Court said:

A standing criticism of the use of the corporation in business is that it causes such business to be owned by people who do not know anything about it. Argument has not been supposed to be necessary in order to show that the divorce between the power of control and knowledge is an evil.¹

The main fact seems to be this: The stockholder does not apparently consider himself other than a mere investor.²

Stockholders of all classes have become apathetic and indifferent with respect to their legal rights. Whenever they believe themselves mistreated as stockholders or suspect that the affairs of the company are being mismanaged, they usually sell out as best they may. Seldom do they protest, or institute legal proceedings. They do not attend meetings, frequently fail to send back prepared proxies, and make it generally difficult for the management to secure approval of amendments involving new financing, enlargement of purposes, sale of assets, merger, or other deals, sometimes involving the factor of time, with bankers, underwriters, or others. As a result corporations take advantage of incorporating under states with liberal charter-granting provisions, cutting down the stockholder's legal rights, and participation in the company's affairs. Stockholders are deprived of voting rights by the common use of voting trusts and of issuance of voteless stock.

¹Liggett Company v Boldridge, et al., 1928, U. S. Supreme Court, No. 34, October Term, 1928.

²Of course, a different situation may be present in a small closely held corporation where management and the stockholders are one and the same.

However, at least one governmental agency is interested in preventing the dissipation of the shareholder's voting privilege. Under the Public Utility Holding Company Act of 1935 (sec. 7 [C]), the Securities and Exchange Commission may not authorize the sales of a security of a registered utility without preference over and having at least equal voting rights with any outstanding security of the declarant.³ In another federal law, Sec. 216 (12) of Chapter X, of the Federal Bankruptcy Act requires that reorganization plans must include provisions prohibiting the reorganized company from issuing voteless stock.⁴

It may be said that the stockholder definitely conceives of the corporation as being an entity separate and distinct from himself.

Management

Since a corporation is not an individual and since the stockholders have no inherent right to participate directly in the management of corporate business, it is clear that all business must be conducted through the medium of paid management employed and supervised by the board of directors. Stockholders participate in management

³H. G. Guthman and H. E. Dougall, Corporate Financial Policy (New York: Prentice-Hall, Inc., 1948), p. 61.

⁴Ibid.

only by the indirect and rather remote control they exercise through their privilege of electing directors of their choice. In large corporations even this right is of limited value, since existing directors control the machinery by which proxies are obtained, thus making it a simple matter for directors to perpetuate themselves in office or to select their successors.

Unusual matters, such as voluntary liquidation, merger, consolidation, or amendments to the charter, must be referred to the stockholders for their approval. Ordinarily, by reason of by-law, charter, or statutory provision, a quorum at a stockholders' meeting consists of a majority of stock, and a majority of shares present in favor of a proposition is sufficient to carry the proposal, except in those unusual cases where statute requires a larger portion to approve certain courses of conduct. It is quite customary for a board of directors at an annual meeting to request the stockholders to approve of such action as they have taken during the year immediately prior to the time of the annual meeting.

Management has an apparent free reign to conduct the business as it sees fit. A stockholder is not burdened by any fiduciary relation to the corporation. He is free to contract with it as though he were a stranger and to vote for his own personal interests, but the majority, acting through their chosen directors, may not operate the corporation for their personal profit at the expense of the

minority interests. They are obligated to operate it for the best interests of the corporation as a whole.

The management of a corporate entity is under a number of pressures from various sections of our economy. Subject to all these pressures, management has come less and less to consider itself responsible to the owners and more and more to accept responsibility for the corporation as a whole. It does not oppose the demands of the other parties in the interest of the owner, but on the contrary, attempts to satisfy them all, and management strives to provide dividends for stockholders, high wages for employees, friendly relations with government and the public. In a sense such a point of view might be interpreted as enlightened self-interest of management, enlightened stockholder interest, but typically it goes beyond that in the interest of permanence.⁵

Thus it would seem that the management group also has endorsed the entity concept of recognizing the business as a unit separate and distinct existing in its own right.

Creditors' View of the Entity

Limited liability is a characteristic of the corporate form of business. This means simply that the individual fully paid-up stockholder in a corporation may lose all of

⁵Oswald W. Knauth, "Group Interest and Managerial Enterprise," The Journal of Industrial Economics, I, No. 2 (April, 1953), 89.

his original investment but that he is responsible for no further capital contribution.

This is a most important characteristic from the creditors' viewpoint, since the creditor must look to the corporate entity for a payment of his claim and cannot, as in the other two forms of organization, make up any deficiency direct from the proprietors.⁶

This limited liability feature generally prevents the stockholder from withdrawing his investment and emphasizes the importance of distinguishing between capital which is not available for dividends and retained income which is available. Many legal accounting troubles have arisen as a result of this necessity.

Creditors must be protected against over-optimistic calculation of corporate profits and their distribution. The natural desire of corporation directors to be "on the safe side" in the computation of profits and declaring of dividends has greatly emphasized the importance of the doctrine of conservatism and accordingly has profoundly influenced accounting practice.

In order to decide how the creditor looks at the entity it will be necessary to establish what it is that

⁶It is recognized that there are certain forms of partnerships which provide for limited liability to some of the partners, however, it remains necessary for at least one of the partners to be a "general" partner and the creditors have recourse against this partner in case a deficiency exists.

persuades the owner of goods, wares, or money to exchange them for a promise of a future payment. The two primary factors that induce one to become a creditor are the desire to lend or sell at a profit, and confidence in the debtor's ability to meet his promise of future payment.⁷

The creditor's confidence in receiving payment in the future is based upon the history, reputation, and character of the entity, supported by adequate accounting reports. Accounting reports are the creditors' principal tool, although not his only one. From the creditors' point of view reporting by the entity represents the most important consideration given the creditor.

It is difficult to generalize which reports would be of most interest to creditors since there are different types of creditors whose interests vary with the kind of credit being granted. Creditors may be classified into three general types: (1) the Trade Creditor, (2) the Bank Creditor, and (3) the Security Holder.

Trade creditors sell their goods or services on a day-to-day or month-to-month basis. Because of this, they are more interested in the immediate financial position of the entity. They will base their judgment of the credit position on the probable flow of cash through the entities' business, the working capital and short range debt position

⁷Milton J. Drake, "Reports for Creditors," The Accounting Review, XXV (January, 1950), 58.

of the debtor, and they will give only secondary consideration to long term indebtedness and earning capacity. The trade creditor's risk is relatively small and can be controlled by refusing to deliver new goods.

Bank creditors are usually in much the same position as trade creditors. The extension of credit by banks may run up to a year in the typical seasonal or temporary financing and, therefore, the interest of the banks is somewhat longer. Accordingly, their risk is greater and they have an interest in more information regarding the entity's position. The working capital protection indicated in the accounting reports is of greater importance to the bank than the trade creditor, as to the entity's earning capacity. These considerations regarding bank creditors do not apply to the bank creditor who loans funds of over a year up to ten years in duration since they fall within the third classification which is the security holder.

The security holder is in a much different position than either of the forementioned short term creditors. The extension of credit runs over a long period and the risk is much higher. Because of this the long term security holder is in a position that is not easily changed. The proceeds of his loan are usually used to expand operations--either by adding to plant and equipment, or to permanent working capital. For this reason security holders do not

depend for repayment upon asset turnover. Their primary protection is the earning capacity of the entity. For this reason they are deeply interested in the reports which reflect possibilities for future sales and the mortality figures for the particular line of business that the entity uses for its main source of revenue.

Many of the problems between the entity and the creditors are the result of legal requirements. The law is concerned with contractual relations between individuals while accounting is concerned with accountability to its proprietors. The law takes the viewpoint of solvency while the accountant takes the viewpoint of the going concern. It would seem that from the standpoint of the creditor, who loans or extends credit for a short term, that the legal requirement would be the most protective. The long-term creditor would be better protected by the accountant's viewpoint of the going concern since he is interested in the long range earning power. However, it has been said that the short run is always of prime consideration since it is the short term entity which develops into the long term entity. The truth in this statement is certainly open to no discussion. Thus it would seem that once again it is the law which determines the viewpoint taken of the entity.

CHAPTER VII

CONCLUSIONS

Summation

Entity theory stems from the double entry method of recording financial transactions. The theory has been perpetuated by the large formation of corporations. The assets and debts are those of the corporate entity, and the entity reports to its constituents (stockholders, bondholders, employees, and the general public) in much the same way as a trustee reports to his cestuis. The corporation "accounts for" resources entrusted to it through its financial reports, in terms of costs and revenues, financing transactions, and the disposition of earnings. Although the "equities" of the various parties at interest are maintained, there is no attempt to measure net worth, in the sense of a proprietor's interest. The right side of the balance sheet thus represents accountabilities (not values, or even precise computations) for legal or equitable interests. The left side of the balance sheet represents assets in terms of costs, not values, because it is cost to which the accountabilities must be related. Income as measured by the matching of revenues with cost expirations is corporate income, and the disposition of income is a corporate

affair, subject only to the maintenance of legal and equitable interest of which the common stock is only one. The whole idea of "net worth" is really abandoned, and the accounting equation is simply the accountability pattern, Assets equals Equities.

Under entity theory, the recognition of revenue is based upon legal and equitable concepts. The test of revenue is the acquisition of new assets by completing transactions with customers. These transactions arise from rendering the service or delivering the commodity which the corporation is set up to provide. Revenue is not an accretion to proprietorship, for proprietorship has no position in the theory. Revenue is the gross "proceeds" (in cash or enforceable claims to cash) from the sales of product or service representing the main line of corporate activity.

In the shift from proprietary to entity theory, the concept of expense also changed. The proprietary notion of expense was that of outlays made by the proprietor. In terms of accrual accounting this was cost "incurred" by giving up assets or by incurring debt, as well as through cash disbursement; but the notion of expense was still that of a reduction of net worth. Even though it might be recorded under several classifications, expense was "outgo" under proprietary theory in almost the same sense as in personal accounting, and it, therefore, carried a flavor of undesirable though necessary sacrifice.

Under entity theory, however, expense is the cost assigned to the production of revenue. The business unit (entity) is one part of the vast machinery of production and distribution of goods and services. As a part of the business system, the firm is a device for conversion of goods and services into new and different forms. Expense is simply the financial measure (cost) of the product of the firm. Thus manufacturing, selling, and even over-all administration costs are but financial expressions of the service delivered to customers in the market. Services acquired by the firm, but not yet delivered to customers are assets. Assets are thus "postponed costs," so long as they remain available for conversion and delivery. In this latter sense even cash and receivables are "services" available for future conversion and delivery. The nature of an asset is thus not directly related to physical existence of property or its value in exchange. An asset is the cost applicable to services available for future conversion and delivery to the market.

The reporting of operations under entity theory puts emphasis upon corporate income, measured by matching cost-expirations with revenue for the period. Corporate income accrues not to stockholders or owners, but to the corporation. Corporate income is thus freed from the proprietary connotation of profit related to increased net worth.

Entity theory tends to recognize financing transactions and income distributions as distinct from either

proprietary or income-determining transactions. Thus, although it is not generally agreed in practice, it would seem that under entity theory interest charges are distributions of income, not expense. Similarly dividends (in the ordinary sense) would be regarded as income distributions rather than proprietary withdrawals of capital. Taxes on net income also would seem to fall in the category of distributions of income rather than determinants of "profit." The underlying basis for these conclusions is the concept that the corporation is an entity separate from any of the parties at interest; and that it--not the stockholders--is the center and objective of accounting. The financial statements are the reports of the management, about the corporation. These reports are directed to all interested parties, without preference or prejudice, and no attempt is made to meet the specific needs or concerns of particular groups in those reports.

Speculation

Perhaps it might be fitting to speculate as to the future of the entity as a basis for accounting theory. It was suggested, in an accounting theory seminar (which the writer had the privilege of attending) that the corporation was a natural step in the evolution of business enterprise. This statement seems to gain in support when one notices the increase in the organization of corporations every year. If this be true then it can be expected that more

consideration will be extended to the entity theory.

It will be necessary for courts of law to further deprive stockholders of their rights and privileges as owners before many accountants will be willing to recognize the entity as being a person separate and distinct. This trend seems to have taken place over the last half century. It is the opinion of the writer that the entity concept is a natural evolution of a social type theory of enterprise. The entity as an institution being created for the purpose of benefiting society rather than the relinquishing of rights to a small select group of stockholders. The writer having very little training in political science is nevertheless willing to predict that the granting of immunity given by the state in the formation of a corporation will not go unregulated. Stricter controls will be effected and accountants will be forced to adopt their conventions and principles to fit a social type institution. Social accounting is a subject of many current articles written in the professional publications which make up a part of current accounting theoretical thinking.¹ Apparently accountants have already recognized that the future of

¹Two of the more current social accounting articles are: J. P. Powelson, "Social Accounting," The Accounting Review, XXX (October, 1955), 651; and E. L. Kohler, "Aspects of National Income," The Accounting Review, XXVIII (April, 1953), 178.

accounting will be based on providing information to society as a whole. The entity will expand to include the whole of the country. The present stockholders will be recognized as the bondholders are presently. Their interest will be reduced to a minimum of return on their capital investment. The regulatory agencies of the Federal and State governments will establish accounting doctrines. Therefore, it is a necessity that accounting theory keep pace with the changing economic structure and develop principles which will be in accord with current economic realities. The proprietary theory of accounting was undoubtedly the first of recognized accounting procedure and is being replaced piece by piece with the entity theory. The entity theory will be replaced piece by piece by some further type of social-accounting theory.

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