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Accounting Concepts and Behavioral Hypotheses

Reginald S. Gynther

THE discipline of accounting suffers in many ways from our inability to devise, deduce, or build a general theory on which to base the many necessary lesser theories for specific events, operations, organizations, etc. Until this general theory is produced we will continue to operate with the variety (and often duplicity) of theories which cannot be interrelated or fitted to any one framework of accounting in a logical fashion. Unbeknown to the participants, many debates on accounting "theories," practices, and procedures stem from differences in their basic concepts of accounting. As Oliver Wendell Holmes once said:

> I will tell you what I have found spoil more good talks than anything else; long arguments on special points between people who differ on the fundamental principles upon which these points depend. No men can have satisfactory relations with each other until they have agreed on certain ultimata of belief, not to be disturbed in ordinary conversation, and unless they have sense enough to trace the secondary questions depending upon these ultimate beliefs to their source.[1]

This paper is a humble attempt to open the door far enough to permit a little light to be thrown on these matters in the hope that we might proceed a step further towards a general theory of accounting. After examining what appear to be looked upon as the main concepts of accounting and the different attitudes and consequences involved, we shall analyze some of the underlying behavioral factors causing the existence of these different perceptions. It will then be suggested that these underlying behavioral factors nullify two notable attempts to provide a solution to this dilemma; and reasons for the apparent irreconcilability of the various basic concepts will be given. A discussion of the implications for the future and the author's suggestions will then follow.

Different Perceptions of the Firm

The subject of "basic concepts of accounting" is one that has often been discarded, only to be stumbled upon by another academician and to be dragged out of the corner for another "chewing over" before being discarded once again. With few exceptions, basic textbooks have ignored the matter, and it is seldom, if ever, discussed outside academic circles.

Over the years two main concepts,[2] the proprietary concept and the entity concept, have been discussed at odd times in

[1] Baxter, W. T. (ed.), *Studies in Accounting*. (Sydney: Law Book Co. of Australasia Pty. Ltd., 1950). p. 243.
[2] Sometimes referred to as "theories."

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the literature, and there have been occasional appearances of refinements, modifications, and alternatives reflecting slight variations in viewpoint,[3] as well as attempts at reconciliation.[4]

The Proprietary Concept

Those who hold the proprietary concept perceive the firm as being owned by a sole proprietor, a set of partners, or a number of shareholders. The firm's assets are looked upon as being the property of these people and the liabilities of the firm are their liabilities. "The business is merely a segregated portion of their financial interests, accounted for separately because it is convenient or necessary for various reasons to do so."[5] The proprietors are the center of interest at all times, and their viewpoints are the ones reflected in the accounting records. Total assets minus total liabilities equals that portion of their net worth that is vested in the firm. Revenue and expense items immediately increase or decrease this net worth, which is another way of saying that profits are perceived to be the property of the proprietors (and not the firm) at the time they are earned, whether they are distributed or not.

When corporations do distribute dividends, they are seen to be actually placing in the hands of the proprietors something which has been part of their private individual property for some time. Payments of interest and taxation by the firm are expenses to the proprietors and reduce their net worth in the same way as the firm's other operating expenses do. Where the firm does pay taxation, there is "double taxation."

However, there are different shades of the proprietary concept, depending chiefly in who is perceived as belonging to the proprietorship group. Husband sees the proprietorship function belonging to those who really are entrepreneurs, and "on the theory that the common stockholders occupy the entrepreneurship position in the corporation, preferred stock, like bonds, represents hiring of capital service. Consistent therewith, preferred stock dividends are best treated as a cost."[6] This is the narrowest version of the proprietary concept and it appears to be identical to the "residual equity" concept which has been put forward by Staubus. He also sees the proprietors of the firm as being the ordinary shareholders only:

> Those who have been friendly to the proprietary theory should see some merit in narrowing the focal area to a single point by excluding preferred stock (unless it is participating preferred). . . . In the residual equity theory, all investors in a corporation except common stockholders are thought of as outsiders.[7]

However, Lorig's perception of the firm is such that he widens the proprietorship group to admit the preferred shareholders:

> Just who constitute the proprietors in a business corporation is not entirely clear. Certainly the common stockholders are included. The preferred stockholders also are generally considered in that category, though normally they have no voice in operating the business. In practice, the financial return to them is always considered a distribution and is chargeable only to net profits, current or

[3] For example, Suojanen, W. O., "Acounting Theory and the Large Corporation", THE ACCOUNTING REVIEW, July 1954, pp. 391–398; Husband, G. R. "The Entity Concept in Accounting," THE ACCOUNTING REVIEW, October 1954, pp. 552–563; Sprouse, R. T., "The Significance of the Concept of the Corporation in Accounting Analyses," THE ACCOUNTING REVIEW, July 1957, pp. 369–378; Staubus, G. J., "The Residual Equity Point of View in Accounting," THE ACCOUNTING REVIEW, January 1959, pp. 3–13; Li, D. H., "The Nature of the Corporate Residual Equity Under the Entity Concept," THE ACCOUNTING REVIEW, April 1960, pp. 258–263; Li, D. H. "The Nature and Treatment of Dividends Under the Entity Concept," THE ACCOUNTING REVIEW, October 1960, pp. 674–679; Lorig, A. N. "Some Basic Concepts of Accounting and Their Implications," THE ACCOUNTING REVIEW, July 1964, pp. 563–573.

[4] For example, Vatter, W. J., *The Fund Theory of Accounting and Its Implications for Financial Reports*, (The University of Chicago Press, 1947); Goldberg, L., *An Inquiry into the Nature of Accounting*, (American Accounting Association; 1965), pp. 162–174. These are discussed later in this paper.

[5] Lorig, A. N., op. cit., pp. 564–565.

[6] Husband, op. cit., p. 561.

[7] Staubus, op. cit., p. 12.

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accumulated, and payable only when declared in the form of a dividend. Both classes of stockholders, therefore, are distinctly different from the creditor group, and this distinction is basic in the proprietary concept.[8]

Then there is the minority who see *all* long-term investors as being proprietors of the firm—i.e., bond and debenture holders as well as shareholders. For example, Chow considers that "a concept of proprietor broadly defined as the totality of private interests or the long-term investors as a class would be more logical and workable from the standpoint of theory and practice."[9]

The Entity Concept

The entity concept, like the proprietary concept, is a viewpoint, an attitude of mind; and it, too, is not confined to accountants. For example, Eells and Walton say:

The perception of managers is often such, that the shareholders as well as the creditors are outside the organization which they are concerned in operating;[10]

This is the essence of the entity concept of accounting. The holders of this concept see the entity as something separate and distinct from those who contributed capital to it. They see the assets and liabilities as being those of the entity itself and not those of the shareholders or proprietors. As profits are earned by the entity, they become the property of the entity; they accrue to the shareholders *only* if and when a dividend is declared. It follows that any undistributed profits remain the property of the entity and constitute part of the entity's "equity in itself"[11] in the eyes of those who hold an entity concept, and this is not affected by the inclusion of undistributed profits in the stockholders' section of the printed balance sheet. The entity concept person sees this as mere conforming to conventional and regulatory reporting procedures.

It should be emphasized at this stage that those who have the entity viewpoint actually see the net assets as being the property of the entity itself, and not that of the shareholders. A few writers have indicated that the mere creation of a separate accounting system for the entity's activities provides evidence of the existence of the entity concept, but it is suggested here that these few writers do not perceive the firm in the way a holder of the "pure" entity viewpoint does.[12] The "independence" or "separateness" of the entity's accounting records is commonly referred to as the "entity convention" and not the "entity concept." If the hot dog vendor maintains separate accounting records for his business as he should (the entity convention), it does not follow that he has an entity viewpoint regarding the business—although this is possible.

It is to be noted that in the proprietary theory, as well as in the entity theory, the business is the center or the area of attention. No extended argument is necessary to establish that the area of

[8] Lorig, op. cit., p. 565.

[9] Chow, Y. C. "The Doctrine of Proprietorship," THE ACCOUNTING REVIEW, April 1942, p. 162.

[10] Eells, R., and Walton, C., *Conceptual Foundations of Business*. (Richard D. Irwin, Inc.; 1961). p. 149. W. A. Paton, in his remarkable book published 44 years ago (*Accounting Theory*, The Ronald Press Company; 1922), was probably the first to recognize *and* describe this entity viewpoint.

[11] Husband, op. cit., p. 554.

[12] For example Louis Goldberg says, "The entity theory—or, as it is frequently referred to, the entity convention—has been the subject of varying degrees of exposition", op cit., pp. 109–110; and "if we take the entity theory to its ultimate end, we reach the stage where a person may become an (accounting) entity distinct from himself," *An Outline of Accounting* (Sydney: Law Book Co., 1957). p. 29.

Gilman, S., in *Accounting Concepts of Profit* (The Ronald Press Company; 1939), tends to blur the "entity convention" and the "entity theory" together. (See Chapters 4 and 5) At page 47 Gilman says, "Accounting records are still written from the *viewpoint* of an entity until it has now become an accounting convention" (emphasis added). Incidentally, although Gilman seems to profess to hold the entity viewpoint (p. 64), he says at p. 52, "The entity is as soulless and automatic as a slot machine. . . . In and of itself the entity makes no profits, suffers no losses"; and "increases in entity property automatically become additional liabilities to the proprietor." See further "proprietary-type" statements of his on pp. 61, 87, 88, 123, 246, and 604.

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attention for a given set of records and reports must be limited.... Hence, both proprietary and entity theory recognize the independence of certain activities from each other for accounting purposes; and the unit of accounting under either theory is the business venture or enterprise.[13]

It was seen that different shades of the proprietary concept exist, and so it is with the entity concept. Here, too, all those with an entity concept do not perceive the firm in exactly the same way.

Those people who see the entity from a holistic viewpoint look upon all dividend, interest, and taxation payments as being expenses of the entity, and this is the picture of the entity concept that Husband paints so well.[14] All of these are outgoings which reduce the undistributed profits that form part of the entity's equity in itself. This way of looking at the firm is not unlike that in Vatter's fund theory; he has said that "the fund theory viewpoint is something of an extension of entity theory."[15] Li, who might be "accused" of holding an extreme entity viewpoint, looks upon dividends not as a financing cost, as most entity people do, but as being "akin to institutional advertising . . . a cost incurred with a view to the future"; he also says that they may be "viewed as an insurance cost."[16] He sees dividends as being necessary to create both a favorable investment atmosphere and a favorable corporate image, both with the idea of protecting the corporation's objective of survival.

Even though dividends are seen by some entity theorists as being an expense of running the business, the taxation authorities will not allow them to be treated as a deduction for tax purposes. Taxes are calculated on profits before deducting dividends. To this extent, those with this entity outlook also see a form of double taxation.

However, Vatter says that "under entity theory interest charges are distributions of income, not expense. Similarly, dividends 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'."[17] This writer considers that this is not the contradiction that might appear at first sight, but merely the description of the viewpoint of a person who is in charge of production and/or distribution activities for an entity and who is not looking at the entity as a whole. After such a person makes "profits" for the entity, he "hands them over" to top management (which is also responsible for arranging finance for the entity) for the paying of interest, dividends, and taxation. This contention seems to be supported by Vatter:

Under entity theory, 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 converting goods and services into new and different forms. Expense is simply the financial measure (cost) of the product of the firm. . . . Entity theory tends to recognize financing transactions and income distributions as distinct from either proprietary or income-determining transactions.[18]

At one end of the entity viewpoint of the firm continuum, the capital supplied by the stockholders (including undistributed profits) is also viewed as being part of the entity's equity in itself and *not* as a debt of an indefinite nature. For example, Li sees such capital remaining with the entity as long as it remains a going concern and he argues that the lack of a due date "denies a claim" by the stockholder to

[13] Vatter, op.cit., p. 3.
[14] Husband, op. cit.
[15] Vatter, W. J., in *Handbook of Modern Accounting Theory* (M. Baker, ed., Prentice-Hall, Inc.; 1955). p. 367.
[16] Li, op. cit., October 1960, p. 675.
[17] Vatter, in Backer op. cit., p. 367.
[18] Vatter, ibid., p. 366.

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capital contributed. "From the present-value concept, the present value of a claim due at infinity is zero, the same as if there were no claim at all."[19]

The Social Responsibilities Concept

Some people perceive the firm as a social institution that is operated for the benefit of all members and groups in the society. They see the firm as being responsible to stockholders, management, employees, suppliers, customers, the government, and other members of the public. Ladd, for example, says:

> Virtually all segments of the community, including corporation managers, have come to have important interests in the status and progress of the large corporation, which is by way of saying that the corporation has important responsibilities to all of them. These responsibilities are a function of the corporation's role as our principal instrument for the utilization of human, material, and monetary resources in the production and distribution of goods and services, and for rewarding those who provide these goods and services.[20]

Instead of providing a third concept (in addition to the proprietary and entity concepts discussed above), it seems to this writer that the social responsibility ideas concern the way the entity *acts* and the way it goes about carrying out its activities. It seems to be related to ethics, goals, objectives, and the ways of obtaining them, and in no way alters the perception of a firm as an entity owning net assets. In fact, the social responsibility notions seem to fit completely within the entity viewpoint of the firm when the writings of the two main accounting exponents of these ideas are examined.

Suojanen's "enterprise theory"[21] is based on the concept of the large corporation as an "enterprise or institution with wide social responsibilities," and his main (or sole) requirement is in the reporting process where he wants the financial statements to show "value added" as in national income accounting.

> If the enterprise is considered to be an institution, its operations should be assessed in terms of its contribution to the *flow* of output of the community. If the income generated in the enterprise is to be analyzed on the basis of social considerations, then the traditional type of income statement is insufficient.[22]

But Suojanen definitely perceives the firm as a separate and distinct entity; the following statements by him are completely consistent with the way the firm is seen by those with an entity outlook:

> The enterprise theory of the area of accounting application accepts the concept of the large corporation as 'an institution in its own right.'[23]

> The enterprise exists apart from any of the participants.[24]

> The stockholders in an enterprise and their rights are subsidiary to the organization and its survival.[25]

The other main exponent of the social responsibility ideas in the accounting area, Ladd, is also mainly concerned with the reporting function and this is reflected in his strong advocacy of "the uniformity and the degree of disclosure modern conditions require."[26] At the same time, he, too, seems to remain completely within the entity outlook described in the previous section. He thinks that "corporate survival and growth are the principal objectives of contemporary corporations and that these objectives are implicitly accepted by most of those to whom corporations are responsible."[27]

To summarize, it is thought that the social responsibilities idea is an adjunct to the entity concept, and that it concerns the way the entity carries out its activities in

[19] Li, op. cit., April 1960, p. 261.
[20] Ladd, D. R., *Contemporary Corporate Accounting and the Public* (Richard D. Irwin, Inc., 1963), p. 13.
[21] Op. cit.
[22] Ibid., p. 395.
[23] Ibid., p. 393.
[24] Ibid., p. 394.
[25] Ibid.
[26] Ladd, op. cit., p. 165.
[27] Ibid., p. 18.

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society and the reports back to the members of that society.

Economic Theories of the Firm

It is clear that the entity and proprietary concepts of the firm are also present in the discipline of economics, but they do not appear to have been delineated and labeled as clearly there as they have been in the discipline of accounting. McGuire says that this area has been "clouded by the economists who discuss the enterprise and the entrepreneur as one and the same, and who sometimes term profits the returns to the firm, and at other times talk about profits as the return to the firm's owners"; and that "there appears to be little unanimity among economists on the proper answer to the question: are profits a return to individuals or to business units."[28]

McGuire considers, and this writer agrees, that most economists have the proprietary outlook and perceive "the net income stream flowing to the owners of the firm";[29] and he finds it difficult to "accept the convenient fiction of the impersonal institution—the firm—as an ultimate income recipient separated completely by convention from the people who inhabit it."[30] The viewpoints of the economists Due and Bober are identical to those of Husband, because they see the stockholders, even in the modern large corporation, making the decision to hire, fire, or retain the management; and they therefore are really the entrepreneurs.[31]

Stauss and Davis, however, are representative of those economists who adopt the entity concept and who look on the firm itself as the entrepreneur and on profit as the net income of the enterprise.[32] This, of course, eliminates the inconvenient "undistributed profits" from the economic models.

The proprietary concept seems to personify the traditional, classical ideology of capitalism. This is reflected in a statement by the economist, Milton Friedman, a prominent advocate of that ideology, when he decries the concept of social responsibility that many corporate officials "profess" to have adopted:

> Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for the stockholders as possible.[33]

Also, "The corporation is a instrument of the stockholders who own it."[34]

The entity concept, on the other hand, seems to be the essence of Monsen's "managerial ideology of capitalism,"[35] which sees the business man and the large corporation as having replaced the entrepreneur. This ideology is also tinged with the idea of social responsibility, which we saw previously is consistent with the entity concept.

Consequences of the Different Viewpoints

In the sections above on the proprietary and entity concepts, it was seen that the different ways of perceiving the firm resulted in different ways of viewing profits. Several different ways of looking at the treatment of interest, dividends, and income taxes in the profit determination process were discussed.

Lorig lists differences in accounting and reporting that he sees as being caused by

[28] McGuire, J. W. *Theories of Business Behavior* (Prentice-Hall, Inc.; 1964), pp. 52–53.
[29] Ibid., p. 54.
[30] Ibid., p. 53.
[31] Due, J. F. *Intermediate Economic Analysis* (Richard D. Irwin Inc.; 1951), p. 415; and Bober, M. M. *Intermediate Price and Income Theory* (W. W. Norton & Company, Inc.; 1955), pp. 425 ff.
[32] Stauss, J. H. "The Entrepreneur: The Firm," *Journal of Political Economy*, June 1944, pp. 112–117; and Davis, R. M. "The Current State of Profit Theory" *American Economic Review*, June 1952, pp. 251–252.
[33] Friedman, M. *Capitalism and Freedom.* (The University of Chicago Press; 1962). p. 133.
[34] Ibid., p. 135.
[35] Monsen, R. J., Jr., *Modern American Capitalism—Ideologies and Issues.* (Houghton Mifflin Company; 1963). pp. 25–29.

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the existence of the two main viewpoints.[36] However, it has been shown above that there are several gradations or shadings within both the proprietary and entity concepts, and for this reason it might be difficult to find many that would agree with all of the specific differences that he lists using his perception of these viewpoints. For example, he says that a person with an entity concept would probably create a charge (and accrue the resultant liability) for arrears of dividends on preferred stock, while a person with a proprietary outlook would not.[37] It is suggested here that Husband and Staubus, whose viewpoints place them at the extreme end of the proprietary concept continuum, would be just as likely as the entity theorist to accrue this item because they see preferred stockholders as being outside the proprietary group and in a category similar to bondholders. On the other hand, we saw that Lorig views preferred stockholders as being in the entrepreneur category. The main point here is that it is difficult to prepare any one comprehensive listing of differences to depict all the various viewpoints within the two main categories.

Much of the Lorig list relates to ways in which items are treated in financial statements prepared for the purpose of reporting to stockholders, and this writer does not believe that these financial statements necessarily reflect the attitudes or concepts of the firm or of those responsible for preparing them. When statements are being prepared, every consideration must be given to agency regulations, convention, and the style and methods used on previous occasions. Further, it is thought that a person with an entity viewpoint might deliberately prepare these statements in the way he thought they would please the shareholders. For example, Li can be imagined to be expanding his "institutional advertising" in this fashion.

Lorig suggests that all those with an entity concept are not interested in revaluing assets in times of changing price levels, while those with a proprietary viewpoint are.[38] People with an entity viewpoint are usually most concerned with the survival and growth of the entity, and besides other things this entails ensuring that all assets are being used profitably within the various divisions of the organization. To control this and the performance of managers effectively, it is necessary to look at the current values of the assets employed and the divisional profit percentages on those current values. Revaluations of assets are often necessary to enable this to be done. To the entity person such revaluations of assets would result in increases (assuming rising prices) to the entity's equity within itself (and not to stockholders' funds), and while this is not "meaningless" it is certain that entity people concentrate their attention mainly on the asset side of the balance sheet.

However, there are some significant differences between the entity and proprietary concepts in the *way* that assets are revalued. These will be dealt with later in this paper.

Some Behavioral Hypotheses for the Different Concepts

The same firm, i.e., the same set of "facts," can be seen in several different manners, which merely illustrates a matter that psychologists have been concerned with for many years. What is an "objective fact" is often only that which is perceived as being such by an individual. Each of us sees the world in a manner slightly different from the next one; many variations in perception are possible.

[36] Lorig, op. cit.
[37] Ibid., p. 571.
[38] Ibid., p. 572.

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> The world-as-we-see-it is not necessarily the same as the world-as-it-"really"-is. Our answer depends on what we heard, not on what was really said. The housewife buys what she likes best, not what is best. Whether we feel hot or cold depends on us, not on the thermometer. The same job may look like a good job to one of us and a sloppy job to another.[39]

The realization that different perceptions are often possible brings tolerance and permits the acceptance of other viewpoints as "legitimate"; but as Stagner has pointed out, people often become so strongly involved in a situation that they fail to distinguish between their own personal involvement and the specific facts.[40] This is particularly so in situations involving conflict.

Reasons for Different Perceptions

The matters of perceptions, attitudes, frames of reference, values, reference groups, group norms, environment, culture, and personality systems overlap and are inextricably interrelated in interacting patterns. As many volumes have been written concerning these matters, the discussion here can do no more than give a scant outline necessary to an understanding of the issues at hand.

To understand the manner in which man responds to and copes with his social environment, we must know what that environment is to him. Although it is certain that those things that seem to be aids to the satisfaction of one's needs tend to be perceived more quickly than other things,[41] perception depends to a large extent on the assumptions that an individual brings to any particular occasion. The meanings and significances that we assign to things, people, and events depend on the meanings and significances we have built up into a frame of reference through our past experiences.[42] This frame of reference, which may be called our value system, is something that is molded over the years as we form attitudes to a variety of situations, persons, groups, etc. Katz says, "When specific attitudes are organized into a hierarchical structure, they comprise value systems."[43]

These attitudes are psychological formations learned in the course of our development,[44] and once learned they tend to demand that we react in a characteristic way.

> In our daily life, many of our major attitudes are formed on the basis of short-cut value dictums from other people, *before* we make up our minds ourselves through actual contact with the situations, persons and things. In other words, the relationships are structured, crystallized for us through these value dictums before we form our own attitudes in relation to them on the basis of sufficient facts.[45]

This indicates the impact of "family" on the development of each individual's attitudes; and many consider that this is the major direct influence because it is the "usual filter through which the cultural, class, religious, and other sources flow to the individual" in his early years.[46] Evidence of this is provided by Lipset who, from empirical findings, reported that there was a relatively high congruency between "father's vote and the vote of first-voters."[47]

But there are other important influences on the development of attitudes besides the family. Culture (meaning the customs, habits, traditions, and beliefs that characterize a people or a social group) is a

[39] Leavitt, H. J., *Managerial Psychology* (The University of Chicago Press; 1958), p. 27.

[40] Stagner, R., *The Psychology of Industrial Conflict* (John Wiley & Sons, Inc.; 1956), Chapter 3.

[41] Leavitt, op. cit., p. 36.

[42] Cantril, H. "Perception and Interpersonal Relations", *American Journal of Psychiatry,* February 1957, p. 120.

[43] Katz, D. "The Functional Approach to the Study of Attitudes", in Costello, T. W. and Zalkind, S. S., *Psychology in Administration.* (Prentice-Hall, Inc.; 1963), p. 253.

[44] Sherif, M. *An Outline of Social Psychology.* (Harper & Brothers, 1948), p. 208.

[45] Ibid., p. 228.

[46] Costello and Zalkind, p. 261.

[47] Lipset, S. M., *Political Man* (Doubleday & Company, Inc.; 1963).

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most important influence that varies greatly from one society to another. Anthropologists have shown how different cultures are responsible for vastly different attitudes to many things; but for our purpose in this paper, total culture will not be an important factor because we are examining differences in perception within one culture.

Each individual in this complex society is influenced by the many groups of which he is a member. Geographic, religious, educational, peer, and socio-economic group memberships all provide a person with group norms and standards as to what attitudes he "should" learn; and many of these attitudes relate to both work situations and industrial society.[48] It is not suggested that each individual will take over and internalize all the values of the social groups in which he moves, but they will have some lasting effect on him if he becomes psychologically involved. In some cases, too, the attitudes of people have been developed, not by membership within a reference group, but because they aspire to membership within the group and so adopt its viewpoints.

It follows that it is difficult to validate an argument that a person "should" or "should not" have certain perceptions or concepts of the firm. Why? Because these perceptions and concepts are derivatives of attitudes (via a reference frame of values), and these attitudes, in turn, are a function of many things—including the person's environmental and social history.

Further, it should be mentioned that people are not consciously aware of all facets of their value structure or of the various attitudes that have gone into its construction. Therefore, they are not consciously aware of what their perceptions are or might be in certain circumstances. Much lies dormant in the subconscious awaiting possible motivation.

The hypotheses that follow are based on informal observations made over several years of accountants in public practice, accountants in commerce and industry, businessmen shareholders with holdings of all sizes, graduate students, and others. Most were not aware in the first instance of the terms "proprietary concept" and "entity concept" because discussions under these headings have appeared almost exclusively in the academic writings. It was by discussing matters such as the "property" in net assets and profits, and the treatment of interest, dividends, and income taxes that it was possible to classify their perception of the firm in most cases. Further, it was found that most of these people were not even aware that two different main concepts exist, and that they felt there was or should be only one way of viewing the firm. Their viewpoint, whether strong or not, had remained in their subconscious until the matter was discussed.

Some Hypotheses Concerning the Proprietary Concept

The intention is not to list hypotheses in a formal fashion, but to include them in the general discussion. Some are fairly "obvious" and might not cause debate, but it will be interesting to attempt to prove (or disprove) others by empirical research some time in the future.

It is hypothesised that most stockholders with substantial holdings of shares in corporations have the proprietary outlook, and that this is particularly so with holders of substantial quantities of common stock. Further, it is claimed here that most accountants in public practice have a proprietary outlook, and those with whom this has been discussed seem to agree that this is a result of their adopting the viewpoint of the shareholder when carrying out the many audits of corpora-

[48] Costello and Zalkind, p. 261.

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tions. To most public accountants the prime function of the accounting system is to reflect the interests of the shareholders. In Australia, auditors are actually appointed by shareholders at each company's annual meeting, and their short audit report at the foot of the balance sheet is addressed to the shareholders who appointed them. The examinations conducted by professional bodies of accountancy tend to be oriented in style and flavor towards the proprietary concept, and this results in slanting the preparatory education of public accountants in the same direction. The result is that they tend to see the net assets as really being the property of the shareholders, and they look upon profits as "belonging" to the shareholders as soon as they are earned.

The influence of family in these discussions should not be forgotten. Many wives and children of large shareholders become shareholders, and the proprietary concept is absorbed in the home atmosphere. Many public accountants have followed in the footsteps of their fathers; and even where sons go into different occupations, they often take many parental values with them.

It is certain that most sole proprietors, members of partnerships, and shareholder-directors of small companies look upon the firm with a proprietary viewpoint. It is difficult for many to separate, in their subconscious, their business from their private interests. All is "owned" and tends to be blurred into the one "net worth." In this regard, Bernstein, after looking at profit concepts of large and small firms from his "external" position, said:

> The profits [of the large firm] has an "impersonality" about it, whereas in the case of the small business, the relationship between the entrepreneur and his company's earnings is very intimate indeed . . . . In brief, while conceptually small business profit seems to accrue to *people* big business profit belongs to "the corporation."[49]

However, as claimed in a previous section, most economists have a proprietary concept, and this seems to apply particularly to those who are solid members of the classical school. All economists have been exposed to the classical models of the entrepreneur, especially in their formative years, and it could be that this leaves its imprint. Further, although economists are objectively concerned with the firm, most do their viewing from an external position, which is not the best place to acquire by psychological processes the values of one who is imbued with the welfare and survival of the entity itself. It is those on the "inside looking out," and those associated with such people, who are most likely to acquire, consciously or subconsciously, an entity concept.

It has been suggested by some with whom this matter has been discussed that the proprietary concept is a "carry-over" from the Protestant ethic and the focus on the entrepreneur that preceded the large corporation, and that this concept will gradually fade out of our culture as we get further away from that era, and as we come to accept more and more the separation of management from "ownership" in an advanced corporate society. It could be that the influence of such a culture change would result in all small sole proprietors' looking upon their businesses as something entirely distinct and separate from their private lives and possessions. With regard to culture change Sherif has said:

> In spite of all the forces in society that work toward social change, as a general rule the change in attitudes of individuals and groups tends to lag behind the change in actual conditions. Because of this "cultural lag" many prevalent attitudes are highly at variance with existing facts, social and otherwise . . . . Unless acceptable new anchoring frames are presented, a person will tend to cling tenaciously to the old. The reason for this

[49] Bernstein, P. L., "Profit Theory—Where Do We Go From Here?" *Quarterly Journal of Economics*, August 1953, p. 411.

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psychological fact is wrapped up in ego-involvement.[50]

Some might argue that Sherif's observations have much significance with respect to the proprietary concept.

Then again, others might argue that more people will see the firm from the proprietary viewpoint as (and if) the ownership of stocks and shares becomes more diffused under "People's Capitalism."[51] Over 16 million Americans owned stocks in 1962, but it seems certain that most of the large number of small investors in that number did not look upon themselves as being anything more than "small investors."

When ownership is diffused among thousands of stockholders, the owners are almost indistinguishable from the general public[;] . . . hence the public image of the firm is very likely to be the owners' image too.[52]

None of the many small stockholders with whom this matter has been discussed looked upon themselves as being "owners" of the corporations whose stocks they held; their varying viewpoints seemed to have been conditioned by other factors.

Some Hypotheses Concerning the Entity Concept

It is hypothesized that most corporation employees to whom responsibilities have been delegated (including controllers and accountants) hold the entity concept, and that the higher up the hierarchical scale these people are situated, the more strongly they tend to hold this concept. The majority of these employees, consciously or subconsciously, see the entity as being the owner of both the profits as they are earned and the net assets, and they tend to look upon shareholders as being important to the corporation, but not as owners of it.

It is an almost automatic response for management to assume that all internally generated funds over and above the customary dividend will be used for investment requirements before any other source is given serious consideration.[53]

Those who see payments of dividends, interest, and income taxes as "expenses" of the entity tend to be top executives, while those who see these payments as being "distributions of profit" tend to be members of middle management responsible for the production of such profits. To most controllers and accountants employed by corporations, the prime function of the accounting records is to provide management with data to assist with its planning, decision-making, and control functions.

The influence of the environment within the organization is such that the norms of executive groups include the basics of the entity concept, and these are soon internalized by the group member who becomes psychologically involved in his position. Even the fact that they might be small to medium-sized stockholders in a corporation seems to make little or no difference to the entity viewpoint held by such executives. It is also hypothesized, therefore, that the issue of stock options to executives will not alter the view that their welfare is dependent on and secondary to the survival and success of the entity. They will not see themselves as "owners."

The writer's informal discussions with people have revealed many with an entity outlook even though they have no direct affiliations with corporations. The values of some of these may have been influenced by close relatives who had been corporation executives, but the majority seemed to have been conditioned by the way corporations are structured and by their significant role in our society. Since most

[50] Sherif, op. cit., pp. 241–242.

[51] See Monsen, op. cit., pp. 36–42.

[52] Monsen, R. J., Jr., and Downs, A., "A Theory of Large Managerial Firms," *Journal of Political Economy*, June 1965. p. 231.

[53] Donaldson, G., "Financial Goals: Management vs. Stockholder," *Harvard Business Review*, May–June 1963, p. 125.

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have mentioned the legal restrictions on the withdrawal of profits or capital by stockholders, the fact that stockholders must buy and sell their shares at the stock exchange (and not at the company's offices), and that the average stockholder has no voice in the management of the corporation, it would seem that the fictional legal entity has become real in the perceptions of many. This could be further evidence of the cultural change mentioned in the previous section.

There have been others, of course, who have no significant concept of the firm. Their environmental history had been such that they had not yet been exposed to factors which motivated attitudes of consequence in this area.

Attempts to Reconcile the Basic Concepts within Accounting

Two attempts to reconcile the proprietary and entity concepts within accounting theory will be discussed here. Almost twenty years ago Vatter showed tremendous insight into the need for such a reconciliation when he produced his work on the fund theory of accounting.[54] Then in 1965 Goldberg produced his commander theory.[55] This, he says, "does not destroy either the entity notion or the proprietary theory, but it can be used to reconcile the two."[56]

The Fund Theory of Accounting

Vatter's fund theory of accounting was not designed to be an expression of the way people perceive the firm, even though "the fund theory viewpoint is something of an extension of entity theory," designed "to embrace a less personalistic set of ideas, and to emphasize even more the 'statistical' viewpoint in dealing with accounting problems."[57] He says:

> Under the fund theory, the basis of accounting is neither proprietor nor a corporation. The area of interest covered by a set of accounts is independent of legal patterns or organization. The accounting-unit-area is defined in terms of a group of assets and a set of activities or functions for which these assets are employed. *Such a group of assets is called a fund.*[58]

Such funds can exist in private-enterprise, government, social, and other types of institutions. This way of looking at assets, together with the way Vatter looks on equities and debts as merely being restrictions on the use of these assets (and not as being legal liabilities)[59] and the way he sees the fund itself (the group of assets) as being increased by inflows (revenues) and decreased by outflows (expenses), is consistent with the manner in which those with an entity concept perceive the firm.

However, Vatter intended his fund theory to be an impersonal, neutral notion; and to achieve this end he would include much detail in his financial statements so that the reader might compute the profit figure that meets his own personal needs or desires.

> It might be said that it would be desirable to force the reader of the statement to make his own calculations of income from the data thus presented.[60]

For example, the reader could take as the profit figure the one before or after deducting items for interest, income taxes, dividends, etc., depending on his perceptions of the firm and the set of values that prompt them. The fund theory is "directed primarily at the problem of *reporting*,"[61] but the notions underlying it go much closer to satisfying those with an entity concept than they do those who have a proprietary viewpoint. However, it is believed that the personal values that underlie the proprietary and entity con-

[54] Vatter, op. cit.
[55] Goldberg, op. cit.
[56] Ibid., p. 173.
[57] Vatter, in Backer, op. cit., p. 367.
[58] Ibid.
[59] Ibid., p. 368. "Legally, debts only 'accrue' on their due date."
[60] Vatter, W. J., *The Fund Theory of Accounting and Its Implications for Financial Reports*, p. 36.
[61] Goldberg, op. cit., p. 108.

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cepts nullify (unfortunately) this attempt at a reconciliation.

Nullifying Factors

The fund theory idea is based on the assumption that both entity and proprietary theorists would agree on the inclusion of all the various items in the financial statements (which they interpret to suit themselves), and that both would agree on the way each item is calculated or valued. It is claimed by this writer that such agreement is not possible on certain items and for this reason the preparation of "neutral" financial statements is not a practicable one. Some of the problem items are mentioned in this section.

The entity concept has its emphasis on the firm itself, on its assets and its operating capacity. The proprietary concept emphasizes the interests of the proprietary group in the firm and in its assets. To an entity theorist, a firm's profit for a period could be defined as "the maximum amount expressed in dollars, which, if there were no capital transaction during the period, could be distributed by the firm to its beneficiaries without impairing its operating capacity." To a proprietary theorist, a firm's profit could be defined as "the maximum amount which if there were no capital transactions during the period could be distributed by the firm to its beneficiaries without contraction of the amount of shareholder equity."

These are two different concepts of profit, and they arise out of two different concepts of capital. When prices and values change, different accounting results can be obtained as a result of these different concepts held by entity and proprietary theorists.

As Hendriksen says, assets to the person with an entity viewpoint "represent the rights of the *firm* to receive specific goods and services or other benefits," and "the valuation of assets, therefore, should reflect the value of the benefits to be received by the enterprise."[62] It follows that the entity theorist, when revaluing inventories and non-current assets, will use current market values (or specific indexes in their absence) in order to reflect the new value of the benefits to be received by the firm. Further, the person with the entity viewpoint will see the *total* movement in the current market values of operating assets as being one of a capital nature. That is, it does not result in any increase or decrease in the physical assets (or in operating capacity) which comprises its capital.

On the other hand, although many of those with a proprietary viewpoint would also revalue inventories and non-current assets with the aid of current market values, they would recognize a holding gain (or loss) to the extent that increases in the current market values of these assets are greater (or less) than the movement in the general price index which reflects the change in the purchasing power (to the shareholders) of the shareholder equity.

It is claimed here that those who really hold an entity viewpoint do not see these holding "gains" and "losses" as gains and losses to the firm itself. They would point to the statement by the American Accounting Association's Committee on Concepts and Standards—Long-Lived Assets that holding gains, although forming a part of "total net income," are "not distributable without contraction of operating capacity and therefore do not enter into the measurement of income from ordinary operations."[63] Real entity theorists would then claim that if something cannot be distributed because it would impair the operating capacity of the firm, it cannot really be "profit" to the firm and therefore should not be recorded in the firm's books at all.

[62] Hendriksen, E. S., *Accounting Theory* (Richard D. Irwin, Inc., 1965), p. 396.

[63] "Accounting for Land, Buildings and Equipment," The Accounting Review, July 1964, p. 607.

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There are other proprietary theorists who would actually revalue inventories and non-current assets (as well as shareholder equity) in accordance with the movements in the general price index which reflect the change in the shareholders' purchasing power. Such methods produce different depreciation and costs of goods sold, and hence different profit figures from those calculated from the current market values of the specific assets which make up the entity theorist's "operating capacity."

It is considered that reporting under the fund theory idea could not handle these different perceptions of profit and capital, nor could it deal with holding gains and losses, which are recognized by some but not by others. Further, when prices change if some of the firm's capital has been contributed by long-term bondholders and/or by preferred stockholders, more difficulties are encountered. (Price rises will be assumed in the discussion, but price declines present identical problems.)

To those who see the firm from the proprietary viewpoint, gains are made on capital contributed by bondholders when prices rise because the debt is a fixed one and will be repaid in dollars of a lower value. "Proprietary theory is an expression of events from the point of view of the proprietor."[64] To those who have the extreme proprietary view, similar gains are seen on capital contributed by preferred stockholders. For example, L. A. Wilk says:

> There is no reason to maintain the original purchasing power of preference capital since it is only entitled to a portion of the company's assets equivalent to the nominal value of such preference shares. Capital maintenance reserve will therefore be restricted to maintaining the purchasing power of ordinary capital.[65]

However, to those who hold the entity concept, *all* "obligations are considered the obligations of the corporation itself; there is no significant distinction to be made between common shareholders, preferred shareholders, bondholders, and other long-term obligees."[66] This writer now contends that the viewpoint of a real entity theorist is as follows:

> As far as the firm itself is concerned there is no "profit" on these items of long-term debt when prices are rising. . . . All of these long-term debt items form part of the permanent capital of the firm in the same way as do amounts contributed by shareholders. Therefore, to calculate "profit" on items of long-term debt would be just as illogical as calculating "profit" on funds received from shareholders, i.e., in times of rising prices. It cannot make "profits" out of one sort of capital and not out of another.[67]

Once again, if such profits were calculated on long-term debt, their distribution would result in a contraction of operating capacity—and therefore could not really be profits to the firm as perceived by the entity theorist.

So, reporting under the fund theory idea could not handle the calculation of profits and losses on monetary items when prices rise or fall. Not only do entity and proprietary people have different perceptions of what constitutes profits and losses, but there are also different perceptions within the proprietary ranks.

A matter of smaller importance is that of imputed interest. Those who would actually impute "the interest due to the entrepreneurs" within the accounting records have a strong proprietary outlook. (It is not being suggested that *all* those with a proprietary concept would impute interest.) Those with an entity viewpoint are unable to see any interest accruing to

[64] Goldberg, p. 117.

[65] Wilk, L. A., *Accounting for Inflation* (London: Sweet & Maxwell Ltd., 1960), p. 80.

[66] Sprouse, p. 370.

[67] Gynther, R. S., *Accounting for Price-Level Changes: Theory and Procedures* (Oxford: Pergamon Press Ltd., 1966), p. 140.

See also Hendriksen, E. S., *Price-Level Adjustments of Financial Statements* (Pullman: Washington State University Press, 1961), pp. 86–88.

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the firm itself as time elapses. Here, too, the one set of statements cannot be prepared in a neutral fashion to depict the financial position and results in the ways perceived by both entity and proprietary theorists.

The author has noticed other problem items (e.g., in the areas of goodwill and selecting interest rates for discounting purposes), but the above should be sufficient for the purposes of this paper.

The Commander Theory

In introducing the commander theory, Goldberg says:

> Neither the entity nor the proprietary theory . . . is wholly satisfactory in explaining the point of view from which accounting procedures . . . are carried out. Each is based, fundamentally, on the notion of ownership; ownership, however, is a nebulous concept and is extremely difficult to define and analyse in any way suitable for use as a basic accounting notion.[68]

But even if the notion of ownership is difficult to define or analyze, it is true that it is difficult to avoid having perceptions on "ownership" because our culture is permeated with notions of the ownership of property. Most people do see the net assets and profits of the firm as being the property of either the shareholders or proprietors on the one hand, or of the firm itself (entity) on the other.

Goldberg's commander theory, which he believes should be adopted, is not one that is meant to reflect the viewpoints of most people. He seems to confirm this when he says that "instead of focusing attention upon the corporation as a distinct but abstract entity . . . we *should* direct our attention to the function of control which can only be exercised by human beings."[69] He goes on to say:

> Once the position of the commander is recognised, it becomes clear that accounting functions are carried out for and on behalf of commanders. Accounting reports are reports by commanders to commanders, that is, by commanders at one level of command to commanders at a higher level . . . along a whole chain of command; accounting records are set up and maintained to enable effective reports to be made and to provide documentary evidence for decisions to be made by commanders.[70]

And most importantly he adds:

> Accounting procedures are carried out from the point of view of the commander rather than from the point of view of the owner or from a hypothetical point of view of an artificial entity.[71]

And now we must ask, "What is the point of view of the commander? Is it the proprietary point of view or the entity point of view?"

It is suggested here that the answer to this question depends upon the behavioral matters discussed in this paper, i.e., on his value system, which in turn depends on his environmental and social history. Unfortunately, the commander theory does not seem to provide the reconciliation of the proprietary and entity concepts of the firm within accounting theory.

Implications and Conclusion

At the outset it was claimed that the discipline of accounting suffers from the lack of a general theory of accounting and that this lack is due to the lack of agreement on the basic concepts of accounting. In the previous section under the heading of "The Nullifying Factors," some examples were given of the ways in which the two concepts can (and do) lead to different accounting results because of the varying perceptions people have of the firm. The fact that different accounting results oc-

[68] Ibid., p. 162.
[69] Ibid., p. 163.
[70] Ibid., p. 167.
[71] Ibid., p. 168. Incidentally, it is thought that very few suggest that accounting be carried out from the "point of view of an artificial entity." What is suggested by most entity theorists is that the accounting be carried out from the way they and many others perceive the entity.

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cur makes a reconciliation between the proprietary and entity concepts of accounting impossible. What then is the answer?

Both of these concepts emerge from value frames of reference of people in our society, and it is seldom possible to alter these by sophisticated or theoretical arguments. Therefore, if we want a general theory of accounting, together with the higher degree of uniformity and comparability in accounting and reporting that it will provide (from the small firm through to national income accounting), we shall have to make an arbitrary decision as to whether to base it on the proprietary concept or the entity concept.

This author votes for the entity theory, and in so doing he admits that his twelve years in industry as an accountant-controller before entering academic life have shaped his frame of reference in such a way that he has an entity viewpoint. However, he hopes that the following points, given to support his vote, are devoid of bias and prejudice.

1. The interests of the members of the various subcoalitions interested in the firm depend on the results of the firm (entity) and its survival, and therefore the focus of attention is (should be) on the entity itself, and not on any particular member or subcoalition.

2. "In accounting we should be concerned with expressing the truth (a word of high degree of abstraction) about *the social unit* to which accounts or reports are related, so far as is ascertainable and expressible in the units elected as appropriate for this purpose."[72]

3. It follows that we should not attempt to express the entity's activities within the entity's accounting records from the point of view of the shareholders (proprietary concept). We should be expressing the entity's activities from the point of view of those primarily interested in the survival of the entity (entity concept). As we have seen these two expressions can be very different.

4. The place for the recording of the interests of the shareholder is in his own private accounting records. He is a separate entity, and his records should include his various business investments along with his other assets and liabilities. When his investments are listed on the stock exchange, he does not have the valuation problems that he might otherwise have, and he has no difficulty in forming an opinion as to the way the entities are being managed.

5. In private enterprise economies, capital investments are channelled into the various corporations and different industries by decisions based largely on accounting data. Therefore, the optimum allocation of resources depends to a marked degree on the soundness of the results shown by this accounting data. It is thought that they will be sound only if expressed in the values and costs of the entity itself, and not those of the shareholders.

6. In other words, it is considered that shareholders will be in a far better position to make decisions regarding the buying, selling, or holding of securities if the reports reflect the entity viewpoint, and if they do not contain misleading "gains" and "losses" which are not gains and losses to the corporation itself. If shareholders assume that these items affect the profits that can be distributed now or later, they might make incorrect investment decisions. Further, if they insist, for example, on the distribution of gains on holding long-term debt in times of rising prices, this could have adverse effects on the operating capacity and the survival of the corporation—hence on their own long term interests as shareholders.

[72] Goldberg, p. 5; emphasis added.

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7. The entity concept can form the base for a general theory of accounting that applies to *all* forms of organizations in all kinds of economic and political systems. It can form the base for non-profit, fiduciary, and government organizations as well as the private enterprises. Some have suggested to the author that the proprietary concept can be applied to government organizations, but it is doubtful whether many taxpayers look upon themselves as the proprietors of such organizations.

8. Finally, it seems to this author that the proprietary concept of the firm is a carry-over from the era of entrepreneurial ideology when there was a blurring of the business and private interests of the entrepreneur. He sees a gradual change of beliefs and viewpoints within our culture as enterprise becomes more and more institutionalized, and thinks that this, in time, will result in even the small sole proprietor's seeing a clear distinction between his private and business interests.

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