Equity theories and financial reporting: past, present and future

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Presented at 22nd Annual Conference on Accounting, Business & Financial History,
6-7 September 2010

Abstract

This paper has three aims. Firstly, to remind accounting academics, practitioners and standard setters of the origins and the substance of the equity theories and the debate surrounding them that took place from the late 19th century until the 1970s. Secondly, it seeks to understand why the equity theories do not play a role in current financial accounting and reporting theory, regulation and practice. It argues that never in history has there been a greater need to pick up the search for a comprehensive theory of financial accounting because international financial reporting standards are a reality in today's world, and their development is in the hands of the International Accounting Standards Board (IASB). Thirdly, it sketches the outline of a possible comprehensive theory of financial accounting and explains what we can and cannot expect from such a theory. We need a comprehensive theory of accounting because we need to improve our understanding of how different viewpoints of the publicly held corporation might impact income determination models and disclosure and valuation paradigms, and of the economic and social consequences that accounting and reporting according to the different viewpoints may have. Assuming that the IASB truly has the international public interest in mind, such understanding might impact the IASB Conceptual Framework and international financial accounting and reporting standards in the future.

1. Introduction

This paper has three aims. Firstly, it is intended to remind accounting academics, practitioners and standard setters of the origins and the substance of the debates about equity theories that took place from the late 19th century until the 1970s. Initially, the IASB and the FASB made reference to entity theory and the contrasting proprietary theory in their convergence project. Their *Exposure Draft An improved Conceptual Framework for Financial Reporting; Chapter 1 The Objective of Financial Reporting* stated: "The boards decided that an entity's financial reporting should be prepared from the perspective of the entity (entity perspective) rather than the perspective of its owners or a particular class of owners (proprietary perspective)." (IASB/FASB, 2008: 5). The Exposure Draft and some of the subsequent comment letters (IASB, 2008) showed that neither the origins of the various equity theories, nor their implications for financial accounting and reporting standard setting are clear or well-understood.

Equity theories can be understood as incomplete and unsuccessful attempts at formulating a comprehensive theory of accounting for corporations. Sometime during the 1970s the search for a comprehensive theory of accounting was abandoned by most accounting scholars, regulators and practitioners in favour of working hypotheses and theories of the middle range.[1] The search for a comprehensive theory came to be considered as futile. In its *Statement on Accounting Theory and Theory Acceptance*, the American Accounting Association (1977: 1-2) stated that 'no single governing theory of financial accounting is rich enough to encompass the full range of user-environment specifications effectively'. This trend may have coincided with the shift away from normative to positive accounting research as people increasingly grew frustrated with the lack of analytical rigour in many normative accounting articles. As a consequence of abandoning the search for a comprehensive theory of financial accounting and reporting of corporations and the move toward empirical accounting research, the historical normative equity theories debate was soon all but forgotten.

The central issue in the equity theories is as follows. Equity theories provide different views in answer to the question whose point of view should be taken in the accounting process of companies. (See for example Kam, 1990: 302) In order to answer this question from an international accounting theoretical[2] perspective, it would be necessary to understand what it means to take a particular point of view in an accounting process. With respect to the point of view taken in accounting, equity theories are incomplete attempts at answering the following questions from particular points of view.

1. Why should we analyse and record transactions and events with respect to their effects on:
    - the company's shareholders (proprietary perspective)
    - all the company's providers of financing (older entity perspective)
    - the business entity itself (newer entity perspective)
    - all the stakeholders including non-financial stakeholders and the general public (social perspective)?
2. What does it mean to analyse and record transactions and events with respect to their effects on shareholders, all the providers of financing, the business entity itself, or all the stakeholders?
3. Does a particular point of view in the accounting process lead to a specific income determination model or accounting measurement, valuation and recognition paradigm? How would the income determination model or accounting measurement, valuation and recognition paradigm be different if another point of view is taken?
4. What form should the disclosure of information take in each of these cases?

[1] According to Riahi-Belkaoui (2004: 84), Robert Merton introduced and defined 'theories of the middle range' as theories in between working hypotheses and a unified theory. (Merton, Robert K., 1967: 39)

[2] I am not sure if there is such a thing as international accounting theory. It is meant here as a comprehensive financial accounting and reporting theory that is general enough to apply across users and environments, and specific enough to offer assistance to the IASB as well as local accounting regulators in setting accounting and reporting standards and evaluating their social, economic, financial and legal consequences. The IASB Conceptual Framework can be interpreted as an incomplete and somewhat biased attempt to establish international accounting theory.

5. Do different points of view require different accounting concepts or even conceptual frameworks? What are the social, financial, economic and legal consequences of different points of view for any of those with a financial or other interest in a company?
6. If financial accounting and reporting regulation is premised on being in the public interest, how should we define the public interest?
7. What interests does each point of view and associated income determination model and accounting measurement, valuation and recognition paradigm serve and how does it do so?

Secondly, this paper seeks to understand why the equity theories, which, as mentioned above, were incomplete and unsuccessful attempts at formulating a comprehensive theory of financial accounting and reporting of corporations, do not play an apparent role in current financial accounting and reporting theory, regulation and practice. Given that the point of view taken in the accounting process of companies is equally essential in each of the three areas, this absence is surprising and requires some investigation. Never in history has there been a greater need for a comprehensive theory of financial accounting and reporting of corporations, because of the current internationalisation of financial reporting regulation. Currently, the IASB does not claim that its Conceptual Framework is an attempt at building a comprehensive theory of accounting.

Nevertheless, if the search for a comprehensive theory of accounting was abandoned because there is no single theory that applies across different institutional environments and users, then how should we interpret the IASB Conceptual Framework? If the IASB is serving the international public interest as it says in the IFRS Constitution[3], it would do well to recognise the need for developing an international accounting theory in the form of a comprehensive theory of financial accounting and reporting of corporations that applies across all users and institutional environments. For this purpose, increased understanding of different environments and users as well as equity theories could contribute to the construction of a conceptual (and theoretical) framework that holds across national, ideological and developmental boundaries. In other words, the internationalisation of business, capital markets and financial accounting regulation has returned the search for a comprehensive theory of financial accounting and reporting for corporations on the research agenda.

Thirdly, this paper sketches the outline of a possible comprehensive theory of financial accounting and explains what we can and cannot expect from such a theory. We need a comprehensive theory of accounting because we need to improve our understanding of how different viewpoints of the publicly held corporation might impact income determination models and disclosure and valuation paradigms, and of the economic and social

[3] The IFRS Foundation's Constitution at http://www.iasb.org/NR/rdonlyres/B611DD9A-F4FB-4A0D-AEC9-0036F6895BEF/0/Constitution2010.pdf (accessed on 4 April 2010)

consequences that accounting and reporting according to the different viewpoints may have. Assuming that the IASB truly has the international public interest in mind, such understanding might impact the IASB Conceptual Framework and international financial accounting and reporting standards in the future.

Although presently there is a lack of agreement on the precise definition and the concrete accounting implications of the various equity theories, the literature indicates some clear differences between proprietary and entity perspectives of the firm. These differences particularly relate to the purpose of accounting and financial reporting, the distinction between debt and equity and its accounting implications for the analysis and recording of transactions and recordable events, as well as the definition, determination, disclosure and distribution of income.

The remainder of this paper is organised as follows. Section 2 describes the development of equity theories in the past and identifies the main characteristics of proprietary, entity and social theory. Section 3 explores why the equity theories have not been given any prominence in current accounting theory, practice and regulations. It also explains why we need a comprehensive theory of financial accounting. Section 4 explains what a comprehensive theory of financial accounting is and what such a theory can and cannot do. It also sketches the outlines of a comprehensive theory of financial accounting in the hope that other people will be able to help me fill it in.

2. Equity theories in the past

This section is aimed at describing the development of equity theories throughout the history of accounting for publicly held companies. It will consider the following issues.

a. What are the main equity theories?
b. Why did different equity theories develop?
c. What are the basic accounting implications of proprietary and entity theories?
d. What accounting issues remain unsettled?
e. How would disclosure be different under each concept?

2.a. What are the main equity theories?

Throughout the history of accounting, the question of whose viewpoint should be taken in the accounting process of companies has yielded completely different answers that are seemingly irreconcilable. (Newlove and Garner, 1951: 20) One reason that the different answers are considered irreconcilable is that the viewpoints involve conflicting economic and other interests. Another reason is that the viewpoints were considered mutually exclusive because general purpose financial statements must articulate and the accounting standards and process must be internally consistent. Proprietary theorists such as Hatfield (1909), Sprague (1912), and Husband (1938 and 1952), insisted that the accounting process of companies must be conducted from the shareholders' perspective. Staubus (1952, 1959) developed the residual equity theory which considered that the accounting must be done from the perspective of the residual equity holders, which for a going concern coincides with that of the common shareholders. Residual equity theory is often regarded as a more restrictive form of proprietary theory (Belkaoui, 2004: 215).

Early entity theorists such as Gilman (1939), Paton and Littleton (1940), and Chow (1942) held that accounting must take the perspective of both the providers of debt and equity financing because the business enterprise is operating for the benefit of the equity and debt holders (Kam, 1990: 306). Later entity theorists such as Seidman (1956), Raby (1959), and in particular, Li (1960, 1961, and 1963), were convinced that the accounting in companies must be carried out from the perspective of the accounting entity itself because in practice the corporation is operated for the purpose of its own survival rather than in the interest of the shareholders or other providers of financing. (Kam, 1990: 306; and Meyer, 1970: 119) Suojanen (1954 and 1958) introduced the notion that companies have become institutions in their own right and therefore must account from the perspective of the entity which is accountable to society at large.

Meyer (1973) mentions other theorists who do not believe that accounting necessarily needs to take anyone's perspective including Canning (1929), AAA (1957), Vatter (1947, 1962), and Goldberg (1965). These approaches have had little impact on for-profit accounting and will not be discussed in this paper.

2.b. Why did different equity theories develop?

According to Merino (1993: 170), in the first half of the 20th century, proprietary theorists in the USA successfully used proprietary theory to defend shareholders against the threat 'that the corporate form could pose to private property rights'. In the late 19th and early 20th centuries, the democratisation of shareholding together with a tendency towards concentration in industries reduced the ability of shareholders to effectively monitor management. Consequently, managers increasingly administrated corporations in their own interest rather than in that of the shareholders. (See for example Berle and Means, 1932) In the USA, because the Sherman Act had outlawed collusion, between 1898 and 1903, market control came to mean 'owning the industry', which was achieved via mergers. A second wave of mergers from 1918 to 1929 was intended to achieve oligopoly rather than monopoly. (Espeland and Hirsch, 1990: 81) Merino argues that '(b)y developing a model that enabled the stockholder/owner to retain ultimate control and techniques that made good watered stock, thus restoring the integrity of capital, proprietary theorists appeared to reconcile passive ownership with traditional economic justifications of private property rights.' (Merino, 1993: 169)

The owner of a good is the person who 'has the exclusive right to make use of the good, to earn income from the good, and to manage the good and transfer control of it (or to sell it) to another party. (…) It is important to note that the holder of the property right not only has rights but also obligations' (Groenewegen *et al*, 2010: 93). With respect to the traditional economic justification of private property rights, capitalism is based on the assumption that well-defined, secure private property rights and competitive markets will incentivise people to take care of their property and increase their own and total wealth by increasing production, facilitating exchange and allowing market participants to exploit gains from trade. It is presumed that in competitive markets, the capitalist economic system will efficiently allocate resources and fairly distribute the surplus generated by economic activity. Profits are considered the fair reward for skilful entrepreneurial activity and risk taking.

Demsetz (1967) argued that private property rights had developed as a means to counter the negative externalities that are often the consequence of communal property. Hardin (1968) used a scenario sketched by mathematician William Forster Lloyd in 1833, in which herdsmen who maximise their utility in a pasture open to all, end up ruining the pasture. He called the situation where the herdsmen were locked in a short-sighted system that caused them to maximise their own utility by destroying the pasture, 'the tragedy of the commons'.[4] In the late 18th and early 19th centuries, a similar private property argument may have been used to justify the enclosure movement in England at a time of rapid population growth.[5]

Demsetz (1967: 358) discussed three modifications of private property rights in the case of the publicly held corporation, i.e., separation of ownership and control, limited liability, and shareholders' right to sell their shares without approval from other shareholders, as solutions to the external effects that de facto managerial ownership may have on shareholders. Consequently, '(w)hat shareholders really own are their shares and not the corporation.' (Demsetz, 1967: 359) The ability and/or incentives for shareholders to monitor managers, their legal liability and sense of responsibility for any external consequences of the actions of the company have been greatly reduced. In other words, in the publicly held corporation, both managers and shareholders have an incentive to disregard any interests of other

[4] Hardin (1968)'s 'Tragedy of the Commons' claims that in a world with finite resources, there is ultimately no technological solution to the problems associated with population growth and pollution. 'Therein is the tragedy. Each man is locked into a system that compels him to increase his herd without limit – in a world that is limited.' (Hardin, 1968: 1244) 'The tragedy of the commons as a food basket is averted by private property, or something formally like it. But the air and the waters surrounding us cannot readily be fenced, and so the tragedy of the commons as a cesspool must be prevented by different means, by coercive laws or taxing devices that make it cheaper for the polluter to treat his pollutants than to discharge them untreated.' (Hardin, 1968: 1245) Hardin was a biologist concerned with survival. Economists usually believe that the price mechanism solves the problem of finite resources, and that negative externalities can be settled through financial means in the absence of bargaining and other transaction costs. See for example, Coase (1960).

[5] The other justification for the enclosure movement was that the technological developments in the wool industry had made a more productive use of the commons necessary and possible.

stakeholders. Alchian and Demsetz (1972:789) pointed out that '(t)he residual claim on earnings enjoyed by shareholders does not serve the function of enhancing their efficiency as monitors in the general situation.' For this reason, they viewed shareholders, not as joint owners, but as more optimistic (i.e. less risk-averse) investors than bond holders. Such investors care little about voting rights. 'The only difference is in the probability distribution of rewards and the terms on which they can place their bets.' Alchian and Demsetz (1972:789)

Institutional shareholdings, widely dispersed shareholdings, and speculative investors with a less than fleeting interest in the company's welfare, made the definition of company ownership with reference to private property rights more difficult to justify. Therefore, entity theorists insist on accounting according to an entity perspective of the firm which does not make a strong distinction between providers of debt and equity capital. Paton (1922), and Paton and Littleton (1940) advocated entity theory because in their view, limited liability precludes a proprietary perspective. Paton and Littleton (1940)'s entity perspective is closely connected with their advocating the transactions approach (i.e., the revenue-expense approach) to the determination of income and the associated matching of revenues and expenses as well as the realisation concept.

Social theorists, such as Suojanen (1954 and 1958) advocate accounting that, in order to ensure the survival of the firm, accounting is done keeping in mind the interests of all stakeholders including society at large. In practice this meant prudent and neutral determination of income, and the disclosure of the company's value added and the distribution thereof.

2.c. Basic accounting implications of the different equity theories

Accounting for sole traders and general partnerships is done from a proprietary perspective. This means that all transactions and events of the business are analysed and recorded with respect to their effect on the owners. The proprietors own all the assets and have unlimited liability for their debts and obligations as well as their torts. On the one hand, revenues and gains increase their net worth. On the other hand, expenses and losses decrease their net worth. As mentioned before, the capitalist economic system is founded on private property rights, which are premised on the situation that owners have unlimited liability, and that there is no separation of ownership, liability/responsibility and control. Therefore, any conflicting interests between stakeholders such as those between proprietors and customers, proprietors and lenders or creditors, between proprietors and the tax authorities, or between proprietors and the general public will always involve the owners who bear full legal and moral responsibility as well as financial liability in their dealings with outsiders.

For the publicly held limited company, the question of whose perspective must be taken in the accounting process is much more complicated because there is a separation of ownership, liability/responsibility and control, and shareholders have the ability to sell their stake in a company at will. The threefold modification of private property rights makes their economic justification problematic for the following reasons. Separation of ownership and control contributes to the principal-agent problem between shareholders and managers. Limited liability creates corporate governance, legal, financial and moral accountability/responsibility/liability problems of shareholders and managers to all other stakeholders. Furthermore, the ability of shareholders to dispose of shares at will creates a non-committal type of attitude towards social responsibility on the part of managers and shareholders.

Proprietary theory and residual equity theory

Under the proprietary view, transactions and events are analysed, recorded and accounted for as to their immediate effect on the proprietors. Financial statements are prepared from the viewpoint of the proprietors and are meant to measure and analyse their net worth expressed by the accounting equation:

(1) ∑assets - ∑liabilities = ∑equity, proprietorship or net worth

In the proprietary view, the assets are considered the proprietors' assets, and the liabilities are the proprietors' liabilities. According to Newlove and Garner (1951: 21) under proprietary theory "(l)iabilities are negative assets – negative properties, which must be sharply defined and separated in the accounting process." Revenues are increases in proprietorship and expenses are decreases. Net profits, "the excess of revenues over expenses, accrues directly to the owners; it represents an increase in the wealth of the proprietors." (Hendriksen and Van Breda, 1992: 770) Staubus (1959) narrowed the concept of owners to common stockholders and considered preference shareholders as liability holders and stressed the importance to investors of the estimation of future cash receipts. The accounting equation becomes:

(2) *Assets – Specific Equities (=Liabilities + Preferred Stock) = Residual Equity*

The proprietary approach represents an agency view of the company where the main responsibility of management is to manage the firm in the best interests of the owners. As the assets and liabilities are considered the owners' assets and liabilities, the maximisation of profits equals maximisation of the increase in the shareholders' net assets. For this reason, the asset/liability approach to income determination, where income is the by-product of the valuation of assets and liabilities, is the most direct way of quantifying the increase in net assets. Under both the proprietary theory and the asset/liability approach to income determination, it is imperative that shareholders' interests are sharply distinguished from the interests of the providers of debt capital in order to be able to measure the increase in net assets.

Entity theory and enterprise or social theory

Under the entity view, transactions are analysed as to their effect on the accounting entity. Financial statements are prepared from the viewpoint of the entity. The income statement is meant to calculate income for distribution and analyse the company's performance over a period, whereas the balance sheet serves to indicate the security or riskiness of the company's financial position. Under the different varieties of entity theory the accounting equation may take the following forms.

(3) $\sum$*assets* = $\sum$*liabilities* (Paton, 1922)

Or

(4) $\sum$*assets* = $\sum$*equities* (Paton, 1922)

Or

(5) $\sum$*assets* = $\sum$*equities* + $\sum$*liabilities* (Hendriksen and Van Breda,1992: 771)

In the entity view as expressed in equation 3, the assets are considered the company's assets, and the liabilities are the company's liabilities. Alternatively, as expressed in equation 4, the assets are considered the company's assets and the equities are all the financial stakeholders' equities. Entity theory views the entity as "having a separate existence – an arms length relationship with its owners. The relation to the owners is regarded as not particularly different from that to the long-term creditors." (Lorig, 1964: 566) See equation 5.

Suojanen (1954)'s enterprise or social theory sees the large listed corporation as an institution with social responsibilities. Companies' actions affect many different stakeholders such as stockholders, creditors, customers, employees, the government as a taxing and regulatory authority and the public at large. (Hendriksen and Van Breda, 1992; Kam, 1990; Suojanen, 1954) Suojanen traces this institutionalisation of the large enterprise to the separation of management and ownership leading to increasingly large proportions of income being retained within the company to reduce the corporation's dependence on external financing. Large corporations may decide to pay only 'conventionally adequate dividends' because this ties in with their survival and growth objectives. (Suojanen, 1958: 56-7)

Financial reports according to the enterprise theory are to be prepared from the perspective of the enterprise as a social institution. Income generated by the enterprise is analysed to measure the contribution of the enterprise to society using the concepts developed in national income analysis. Therefore, ultimately, the balance sheet is secondary to output, income and value added considerations. The balance sheet equation expressing the enterprise theory according to Meyer (1973: 120) is:

(6) Assets = Investors' input contributions

Suojanen proposes that large companies prepare a value added statement in addition to the balance sheet and income statement. "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." (Suojanen, 1954: 395) "Although stockholders have legal rights as owners, from the point of view of the enterprise their rights are subsidiary to the organization and its survival." (Kam, 1990: 315)

The characteristics of the different theories are summarised in Table 1 below.

Table 1: The purpose of financial reporting, balance sheet equations and income determination

Company view	Purpose of financial accounting	Balance sheet equation	Income determination approach
Proprietary/Agency	Measure net assets and increase in net assets	A – L = E	Asset-Liability
Residual equity	Measure residual equity and increase in residual equity	Assets – Specific equities = Residual equity	Asset-Liability
Entity	Assess performance and determine income for distribution	A = D + E A = L A = E	Revenue-Expense
Enterprise/Social	Assess contribution to society (value added) and performance, and show distribution of value added over stakeholders	A = Input contrib.	Revenue-Expense

2.d. Accounting implications that still need to be clarified

Probably the most extensive study of the accounting implications of different views of the corporation is a dissertation completed in 1956 by Sprouse called *The Effect of the Concept of the Corporation on Accounting* (Sprouse, 1976). He identified 22 items that are affected by proprietary, entity, social and legal views of the corporation and discussed their implications over three chapters. The title of Chapter 5 was 'The effect of the concept of the corporation on the accounting for transactions involving the corporation's securities.' Included were issuance of capital stock, retirement and reissuance of treasury stock, stock dividends, stock split-ups, conversion of capital stock, issuance of bonds, retirement of bonds at less than book value and of bonds at more than book value. (Sprouse, 1976: Chapter 5) The title of Chapter 6 was 'The effect of the corporation on the accounting for the measurement and the distribution of income.' He discussed revenue and gains, expenses and losses, and interest charges, income taxes and dividends. (Sprouse, 1976: Chapter 6) The title of Chapter 7 was 'The effect of the concept of the corporation on the accounting for other changes in the accounts related to the interests of corporate security holders.' (Sprouse, 1976: Chapter 7) He discussed donations of outstanding shares, donations of assets, the gratuitous forgiveness of outstanding obligations, the appreciation of assets, and the appropriations of accumulated undistributed earnings. Finally, he discussed business combinations.

Lorig (1964: 569) contrasted proprietary and entity theory and indicated some '(c)onflicts in principles and practice arising out of the proprietary and entity concepts'. One central issue is the question whether or not retained earnings belong to the shareholders (proprietary/residual equity) or to the entity (entity/social). One's point of view on this issue could logically lead to different accounting for transactions involving the company's securities. Accounting for revenue, gains, expenses and losses depends on whether financial accounting standards are intended to measure income as the increase in net assets or as the surplus of revenue over expenses. Whether or not one considers retained earnings as belonging to the shareholders or to the entity could have an impact on how to account for what *Statement No. 4* and Bird *et al* (1976: 236-7) called non-reciprocal transfers between an enterprise and its owners. Examples include cash or property dividends, acquisition of treasury stock, and conversion of convertible debt. Accounting for non-reciprocal transfers between the enterprise and entities other than its owners, such as gifts, dividends received, taxes, fines, thefts, and the loss of a negligence lawsuit could also be done differently depending on whether one takes a proprietary or entity view of the corporation.

Around the 1950s, many articles were written on how to account for interest, dividends, income and taxation under the proprietary and entity views. Examples include Husband, 1938 and 1954; Staubus, 1952; Seidman, 1956; Sprouse, 1957; Horngren, 1957; Li, 1960a, 1960b, 1961. Unfortunately, even in this comparatively narrow area there is no complete agreement on exactly what the accounting consequences of each of the views are. It is likely that the effort towards a comprehensive theory of accounting was given up because it was not even possible to obtain agreement on the consequences of each of the views for accounting for income, interest, dividends and taxation.

Confusion also arose because on the one hand, proprietary theorists adopted accounting practices that were inconsistent with the proprietary view such as the concept of conservatism, the depreciation of non-current assets, and reserve accounting which would result in an understatement of distributable income in order to 'protect stockholders from their own rapacity'. (Merino, 1993: 171) On the other hand, the multiple versions of the entity theory were not necessarily consistent with each other. A further factor that contributed to lack of clarity was that the accounting system as described by Paton and Littleton (1940) was based on a combination of entity theory, the revenue-expense approach to income determination, historical cost, and the matching of revenues and expenses. The matching principle came to be equated with historical cost and accrual accounting. In turn, accrual accounting came to be equated with the revenue-expense approach to income determination, but the entity view was lost.

2.e. Implications for disclosure, financial statements and formats

As the main purpose of financial accounting according to the proprietary view of the publicly held corporation is determining the value of net assets and the increase in net assets (Belkaoui, 2004: 215), the most appropriate layout of the balance sheet would be the vertical net assets format arranged in order of increasing liquidity as is common in the UK. A category in-between liabilities and capital would not be acceptable as it would hamper the determination of net assets. The income statement is then secondary to the balance sheet. It would show revenues as the increase in ownership and expenses as a deduction of ownership. Hence, interest and taxation are considered expenses in order to arrive at income attributable to the shareholders. Before the advent of corporation income tax, taxation of corporate profits was considered double taxation as the shareholders would also have to pay taxes over their dividend and other income. In a strict proprietary view, the income statement follows the all-inclusive concept of profits, and all income for the period would be distributed to the shareholders because retained earnings do not exist. However, over time, retained earnings became more common and came to be considered as belonging to the shareholders.

The entity view of the publicly held corporation considers the income statement the primary statement as it enables assessment of performance over the period, and the calculation of dividends for distribution and earnings to be retained in the company. The balance sheet was secondary as it was not meant to indicate the firm's value, but rather to show the company's assets and all the stakeholders' interests in order to give an indication of solvency and the security of any assets pledged as collateral. Prudence and reliability were probably the overriding principles in the entity view. Retained earnings belong to the company, only paid in capital belongs to the shareholders.

In the enterprise or social view, the financial statements as mentioned under the entity view are supplemented by a value added statement which would fit in with a country's national accounts. Experiences with value added statements in Germany and the UK in the 1970s showed that in practice the preparation of value added statements suffers from the same problems as other financial statements.

3. Equity theories in the present

Equity theories do not presently play a role in financial accounting and reporting theory or practice. The recognition and acknowledgement of different views on the publicly held corporation might cause accounting researchers to respect, analyse and understand the reasons for these different views, rather than ignore them or make value judgements about them. Proprietary, entity and social views of the corporation developed out of legitimate concerns about the consequences of the separation of ownership and control, limited liability and the ability of shareholders to sell their shares at will. These problems are still nowhere near to being solved even though publicly held corporations have been around for more than a century. The inherently conflicting interests between all stakeholders of corporations render any agreement on a final resolution highly unlikely.

Nevertheless, as IFRS have been accepted in countries with very different institutions, it is more important than ever that international accounting standard setters search for a comprehensive theory of financial accounting. For this purpose, accounting researchers and standard setters need to better understand the different roles of financial accounting in environments that are divergent in terms of capital market development, economic development, economic and political ideology, and any other institutional aspects. The equity theories could form a starting point for creating internally consistent accounting paradigms based on each of the views on the corporation without any concern for the accounting paradigms' political and ideological viability. One problem with the IASB/FASB Conceptual Framework as a source of financial accounting theory is that it is primarily suited for financial reporting and capital markets in the USA. Another problem is that the exposure drafts and comments form an ad hoc consensus process, which makes the outcome a matter of political influence and serendipity, and possibly inconsistent, biased and incomplete.

The IASB/FASB Conceptual Framework convergence project is currently working on a definition of the reporting entity. Its Exposure Draft ED/2010/2, for which comments were to be received by 16 July 2010, describes the reporting entity as:

> *a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided. The reporting entity concept is intended to further this objective.* (IASB, ED/2010/2: RE2)

Note that the IASB Exposure Draft is talking about the reporting entity instead of the business entity, the economic entity or the accounting entity. The objective of financial reporting in the conceptual framework refers to a 'reporting entity' and therefore the IASB is of the opinion that a reporting entity needs to be identified. (IASB, ED/2010/2: BC4) The conceptual framework is concerned with financial reporting and does not refer to financial accounting.

In a letter dated 15 July 2010, the European Financial Reporting Advisory Group (EFRAG) responds to the Exposure Draft and states the following.

> *We consider that the perspective from which the financial statements are presented is critical and should be discussed in the Conceptual Framework. Clarifying the 'perspective' is important in assessing how to resolve accounting policy issues and is central to considering how to satisfy the objective of financial reporting. Accordingly, we think it is necessary to carry out an in-depth analysis of the implications of adopting either perspective and to ensure they are properly debated.*

Note that EFRAG's letter talks about 'the implications of either perspective'. This refers to either the entity or the proprietary perspective. It does not acknowledge the social perspective or any of the other equity theories. However, it is clear that EFRAG recognises that a perspective is important in resolving accounting policy issues and determining the purpose of financial reporting.

3.a. Why did we forget about the equity theories?

The above historical overview of the equity theories has taught us that the different perspectives of the publicly held corporation developed in response to the three modifications of private property rights. Proprietary theory developed to defend the justification of the private property rights of shareholders as owners of the corporation. Entity theory developed in answer to the recognition that shareholders of a publicly held corporation own the shares but not the corporation or the assets of the corporation. Enterprise theory or social theory developed from the understanding that large publicly held corporations are institutions in their own right, the managers of which ought to be responsible and accountable to all stakeholders including society at large. In other words, the entity view and the social view of the corporation are accounting theoretical expressions of the idea that the traditional economic justifications of private property rights have limited validity in the case of the publicly held corporation.

At various times in history, the modifications of private property rights were considered problematic. In the UK, the South Sea Bubble of 1719-1721 clearly instilled an awareness of the dangers of the joint stock corporation to the extent that it took until the *Joint Stock Companies Act 1844* and the *Limited Liability Act 1855* to give the public limited company a second chance. 'The concept of limited liability was a contentious point in the politics of the mid-nineteenth century.' (Glautier and Underdown, 1994: 6) In the US, the problem of separation of ownership and control was clearly recognised, analysed and described by Berle and Means (1932) and may have led to the development of agency theory. Limited liability and the ability of shareholders to sell their shares at will enable speculation, which constituted the main reason for the establishment of the SEC and the Securities and Exchange Laws in the US in 1933 and 1934. In the Companies Acts in the UK as well as the Securities and Exchange Laws in the USA, the solution was thought to be mandatory public financial disclosure, although the actual standard setting was delegated to private regulators.

The agency theory framework seeks to resolve the problems associated with the separation of ownership and control by means of corporate governance mechanisms and regulations. It does not address the problems related to limited liability and the ability of shareholders to sell their shares at will. Financial reporting regulations were intended to address the problems of limited liability and the ability of shareholders to sell their shares at will. Unfortunately, the very reason for financial reporting and corporate governance regulation seems forgotten. Other roundabout attempts of dealing with these problems include business and professional ethics in accounting and finance, corporate social responsibility and corporate social responsibility reporting. Although professional accountants and financial analysts supposedly adhere to a code of ethics, the ethics they are being taught seems to be for the sake of morality and not as a means of addressing the problems created by the modifications of private property rights. Managers do not even have a professional code of ethics. Some might even consider business and ethics as contradictions in terms.

It seems that the problematic nature of private property rights in the case of the publicly held corporation and their implications for accounting have been ignored or perhaps not been recognised by the IASB. Thus it was possible for the IASB to propagate the entity view as the perspective from which financial statements should be prepared, whilst at the same time issuing financial reporting standards that follow the balance sheet approach to income determination, which is decidedly proprietary.

So why did we forget about equity theories and fail to realise their importance to accounting theory, practice and regulation? Firstly, as mentioned above, in the 1970s, the distinction between positive and normative accounting came to be made, and people had grown impatient with the lack of rigour in many normative accounting writings. Positive accounting theory was not concerned with a comprehensive theory of accounting. Empirical studies are by nature limited to smaller questions. Secondly, the piece-meal approach to regulation within national boundaries fostered a piece-meal approach to establishing and studying accounting standards and their consequences. Thirdly, although many people do recognise the problems associated with the separation of ownership and control, they do not see this as in any way diminishing the justification for the private property rights attached to shareholdings in publicly held corporations as corporate governance mechanisms have been devised to address this problem. Many do not see or are simply not willing to acknowledge the problematic nature of private property rights in the case of limited liability and the ability to sell shares at will. Speculation based on investors' different expectations with regard to future prices is necessary to increase the efficiency of markets. How much speculation makes a market efficient and how much speculation destabilises a market is perhaps an empirical question. How much market efficiency should we require is perhaps an ideological question, which is why even academic discussions on private property rights tend to be coloured by the political divide. Fourthly, since the late 1970s, the political climate in the most powerful western countries has steadily inclined towards deregulation, privatisation and laissez-faire. Central banks and financial regulators make the incentives-stability trade-off in favour of incentives in gambling that fast economic growth will bring prosperity for all, rather than destabilise the financial and economic system. Business schools and institutions extending professional accounting and financial qualifications have reinforced this tendency by uncritically embracing the efficient market hypothesis in finance and accounting education.

4. Equity theories in the future

International financial accounting and reporting regulation is a new area that is being designed right now. International financial accounting until the late 1990s was mainly an area of international comparison and classification. International financial reporting from about 2000 onwards became an area of financial reporting for multinational corporations. It appears that this is still the mindset of many on the IASB. However, when the IASB grudgingly started its IFRS for SMEs project, and when the IMF and World Bank required the use of IFRS as a condition for providing funding and many countries accepting IFRS in the hope of attracting foreign investment, both financial accounting and reporting theory and the IASB Conceptual Framework, developed a need to become both comprehensive and internationally inclusive. The equity theories provide a starting point for the identification of a comprehensive theory of accounting. Although they are incomplete, each theory is an attempt at creating a logical, coherent and internally consistent accounting model from one particular perspective of the publicly held corporation. It extends from clarifying the rationale for choosing one particular perspective, to the purpose of financial reporting and via an income determination model to the format in which information must be disclosed.

A comprehensive theory of financial accounting and reporting would place into one single framework the different views of the publicly held corporation and their associated income determination models, measurement and valuation paradigms and disclosure formats. It would explain what the social, economic, legal and behavioural assumptions are behind the different income determination models, measurement and valuation paradigms, as well as the financial statement formats and other means of disclosure. This clarifies the place of financial accounting and reporting as a social science and gives a foundation for the debate on the purpose of financial accounting and reporting regulation. Is financial accounting and reporting regulation meant to redress imperfections in the market for information? Is it meant to improve resource allocation and distribution in an economy or in the international economy, i.e., Pareto efficiency? Or is it meant to enable all stakeholders in corporations to maintain a minimum level of protection of their interests, i.e., equity? Do we want to increase capital market efficiency? If so, why, how much efficiency should we aim for, and what mechanism accomplishes how much of an increase in capital market efficiency?

A comprehensive theory of accounting and financial reporting would need to clarify the relation between private property rights, common property rights and the role of negative externalities (public costs) in the determination of private income. Proprietary theory disregards negative externalities in the determination of income attributable to shareholders, entity theory disregards negative externalities in the determination of entity income, but social theory determines the creation and distribution of value added which explicitly considers all of society as stakeholders in the corporation as an institution.

A comprehensive theory of financial accounting and reporting would need to reconcile the different views and income determination models, and clarify what their social and economic consequences would be in theory so that they can be assessed in practice. However, it would not be a one size fits all theory.

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