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The Entity Concept of Accounting Theory

Douglas E. Sobolik

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THE ENTITY CONCEPT OF ACCOUNTING THEORY

by

Douglas E. Sobolik

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Lyle C. Steinmiller
Chairman

R.D. Koppenhaver

Stuart H. Lundberg

William Johnson
Dean of the Graduate School

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ABSTRACT

The accounting profession is constantly striving to construct a general theory of accounting as a foundation on which to build the principles and postulates which are so necessary to the profession. There are two basic concepts of accounting theory which now serve as separate foundations: the entity concept and the proprietary concept.

This paper deals with one of these basic concepts, the entity concept. After the entity concept is defined, the history and the development of the concept is traced. At this point the question is asked, "What makes the entity concept unique?" The entity concept's uniqueness is underscored by its treatment of income, interest charges, dividends, and taxation. These areas are the subject of considerable discussion. Also discussed are the attempts to reconcile the entity concept with other theories to achieve the stated goal of constructing one general theory.

Finally, the writer feels that the entity concept most closely conforms with economic reality. However, that is not to say that the entity concept should be accepted as the basic concept for accounting theory. In fact, the author calls upon accounting intellectuals to make a concerted effort to find a solution that will be acceptable to the majority of accountants so that consistent reasoning can be achieved from one accepted base.

CHAPTER I

INTRODUCTION TO THE ENTITY CONCEPT THROUGH COMPARISON AND CONTRAST TO THE PROPRIETARY CONCEPT

Introduction

The accounting profession is constantly striving to construct a general theory of accounting as a foundation on which to build the principles and postulates which are so necessary to the profession. There are two basic concepts of accounting theory which now serve as separate foundations: the entity concept and the proprietary concept. Herein lies the problem: that of reconciling these two concepts into a general theory.

Although this paper will concentrate on the entity concept an introduction to the subject would not be complete without a definition of the two concepts and a discussion of the contrasts between them.

Accounting has found its greatest field of usefulness in recording, classifying, summarizing, and analyzing the data and activities of individual business units. Accounting records classify, summarize, and analyze these activities from the point of view of the enterprise rather than from the point of view of the separate owners who make up the

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Although this paper will concentrate on the entity concept an introduction to the subject would not be complete without a definition of the two concepts and a discussion of the contrasts between them.

Accounting has found its greatest field of usefulness in recording, classifying, summarizing, and analyzing the data and activities of individual business units. Accounting records classify, summarize, and analyze these activities from the point of view of the enterprise rather than from the point of view of the separate owners who make up the enterprise.[1]

Consequently, the accounting concept of the business enterprise is that it is a distinct personality or entity in and of itself. In accounting terminology this concept is referred to as the "enterprise entity concept"[2] or more simply the entity concept.

Conversely, however, many accountants feel that since the assets of the enterprise are also assets of the stockholder, then the liabilities of the enterprise are also the liabilities of the stockholder.[3] In other words the enterprise is not a separate and distinct entity and the accounting profession's responsibility rests solely on accounting for each individual owner's equity in that enterprise.

Entity Concept

The Dictionary for Accountants, by Kohler, defines the entity concept as "the recognition of the accounting process as a molder, identifier, and retainer of economic units, within any field of economic activity."[4] The entity concept,

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[1]Norton Bedford, Kenneth Perry, and Arthur Wyatt, Advanced Accounting - An Organizational Approach, (New York and London: John Wiley & Sons, Inc., 1961), p. 4.

[2]Ibid.

[3]Ibid.

[4]E. L. Kohler, A Dictionary for Accountants, (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1963), p. 199.

like the proprietary concept, is a viewpoint, an attitude of mind; and it is not necessarily confined to accounting thinking. 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 in which they are concerned with operating."[5]

The entity concept of accounting, like that of the managers, is that the entity is something separate and distinct from those who have contributed capital to it. They see the assets and the 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 property of the entity. Profits accrue to the shareholders only if and when a dividend is declared. It follows that undistributed profits, retained earnings, remain the property of the entity. Individuals who hold the entity viewpoint claim that reporting the retained earnings in the stockholders equity section of the balance sheet is a mere compliance with conventional and regulatory reporting practices.[6]

For the most part, people who hold the entity concept look upon dividend, interest, and taxation payments as being expenses of the entity. These expenses represent a reduction of profits and consequently, a reduction in retained earnings

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[5]Robert Eells and C. Walton, Conceptual Foundations of Business, (Homewood, Ill.: R.D. Irwin, Inc., 1961), p. 149.

[6]Reginald Gynther, "Accounting Concepts and Behavioral Hypotheses," The Accounting Review, April 1967, p. 277.

which in turn reduces the equity of the entity in itself.[7]

Proprietary Concept

According to the proprietary concept, the entity being accounted for belongs to one or more persons thought of as the owners and their viewpoint is reflected in the accounting of that unit. The assets of the entity are regarded as their assets and the liabilities are regarded as their liabilities. The business is merely a segregated portion of their financial interests, accounted for separately because it is necessary and convenient to do so.[8] The balance sheet equation, ASSETS-LIABILITIES = PROPRIETORSHIP, familiar to all beginning accounting students, reflects the proprietary concept.

The proprietors or shareholders are the center of interest at all times. Total assets minus total liabilities equals the net worth of the business and this in turn is the owner's equity in the firm. Revenue and expense items immediately increase or decrease the net worth, which is another way of saying that profits are considered to be property of the enterprise at the time they are earned regardless of whether or not there is a distribution of these profits. When dividends are paid they are considered merely as a distribution of property

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[7]Reginald Gynther, "Accounting Concepts and Behavioral Hypotheses," The Accounting Review, April 1967, p. 276.

[8]Arthur N. Lorig, "Some Basic Concepts of Accounting and Their Implications," The Accounting Review, July 1964, p. 565.

that had accrued to the individual owner when that profit was earned. Payments of interest and taxation by the firm are expenses to the proprietors and they are treated the same way as operating expenses. They reduce the net worth. When, in fact, the firm does pay a tax, i.e. a corporation, there is a double taxation.[9] That is to say, the firm's profits are taxed at corporate rates and the individual's dividends are taxed at personal rates.

Comparison and Contrast

We have, in these two main concepts of accounting theory, an apparent contradiction. The entity concept tells us that the business unit is a separate and distinct entity where the profits accrue to the business unit itself and not to the proprietors or shareholders. The proprietary concept, on the other hand, tells us that the business unit is merely the collection point of each individual's proprietary interest in the said business unit. The assets and liabilities of the entity are the assets and liabilities of the individual in proportionate share. Profits accrue to the owners as they are earned as opposed to the entity concept where the owners share of profits is claimed only when they are distributed.

The entity concept as well as the proprietary concept can be applied to a sole proprietorship, to a partnership,

[9] Gynther, Accounting Concepts, p. 277.

and to the corporate form of business organization. However, in the case of the sole proprietorship and the partnership, the proprietary concept is pretty much in accordance with the legal facts of the situation. Partners and proprietors may be called upon to pay the liabilities of the business out of personal assets if the business is unable to pay them.[10] Legally, the debts of the business are a liability of the partners or proprietors and the assets of the business really belong to the partners or proprietors.

In the case of the corporation, however, the legal facts of the situation support the entity concept. The shareholders of the corporation assume no liability for the debts of the corporation and they do not share in the undistributed profits of the corporation until a dividend is paid.[11]

The law thus provides no clear-cut support for either the entity concept or the proprietary concept. It supports each theory in different and varying situations. Obviously, this is an undesirable situation. It is especially undesirable in view of the fact that the accounting intellectuals feel that only one basic accounting concept or one general theory can form the foundation on which accounting postulates and principles are to be built. They feel the one concept or general theory methodology is essential and necessary if the accounting profession is to continue to grow and expand with the business community.

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[10] Bedford, Perry, and Wyatt, Advanced Accounting, p. 5.

[11] Ibid.

CHAPTER II

HISTORICAL ASPECTS OF THE ENTITY CONCEPT

Definition

Although the entity concept has been defined earlier in this writing it might be well to elaborate further so that the fullest understanding of the entity concept can be obtained.

According to the entity concept, the busines unit being accounted for must be considered as entirely apart from the shareholders or other owners. Not only is there a complete self-balancing set of books for the entity, there is an arms-length relationship with the owners. The balance sheet equation does not distinguish between creditors and proprietors but is simply: "ASSETS = EQUITIES."[12] In fact, the relationship with the shareholders or other owners is not too much unlike that of a long-term creditor.

The entity concept has greatly influenced the development of accounting. It has allowed for the extension of double-entry accounting to cover transactions between the business unit and the owner which was not possible as long as there was no distinction made between the business unit and the

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[12]Lorig, Basic Concepts and Implications, p. 566.

owner. Overall, many writers seem to suggest that the entity concept has contributed immeasurably to the rather amazing growth of accounting as a technique for the collecting and recording of business data is a systematic manner.[13]

Development

Double-entry accounting evolved out of simple records of debts receivable and payable. Records of debts were sufficient for bankers, but the merchant of the day wanted to know more about his debts; he wanted factual records of his property as well as his debts and records of cost of goods sold and other business expenses as well as the sales price received. In a word, he wanted more information on which to base his managerial decisions. No doubt this led the merchants to devise records that would supply these answers.

Text-book writers of the day were entirely correct when, in undertaking to make bookkeeping processes more understandable, they wrote of two series of accounts. One series for the various forms in which the proprietor's wealth existed and another for calculating the proprietor's wealth in total. However, other writers who also were trying to make double-entry accounting more readily understandable followed different paths to the same goal. They wrote that all property recorded had been entrusted to the enterprise from outside its

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[13]Bedford, Perry, and Wyatt, Advanced Accounting, p. 5.

boundaries and had thus become dedicated to its purposes.[14] Under this view there would be no place in the records of an enterprise for a proprietor's private transactions. Although not called such at the time, the entity concept was born out of this nineteenth century give and take.

It is interesting to note that the entity concept seems to follow the agent accountability theory. The enterprise, being a separate entity distinct from the sources of the assets it holds, is like an agent holding another's property without true ownership and owing to those owners the duty of careful stewardship and full reporting.[15]

As was stated earlier there was much discussion in nineteenth century literature on double-entry bookkeeping and more specifically what is known today as the proprietary concept and the entity concept. One of the more cogent statements in favor of the entity concept was made by Manfred Berliner, a German professor, in a magazine article in 1887.[16] He stressed the separateness of a merchant's private property and his business capital. Profit or loss in an enterprise indicated the value of services of the proprietor-manager. Expenses were not losses but a part of cost of goods sold. He said he had been teaching this concept to his students as far back

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[14] A.C. Littleton, Accounting Evolution to 1900, (New York: American Institute Publishing Co., Inc., 1933), p. 186.

[15] Ibid., p. 188.

[16] Ibid., p. 201.

as 1870.[17]

Perhaps the greatest significance today of this nineteenth century entity concept is the fact that it fits modern conditions much better than would an extension of the proprietary concept. It was born before the corporate structure became prevalent but yet it fits very well.

Probably the most influential piece of writing to the modern day discussion of the entity concept appeared in 1940. W. A. Paton and A. C. Littleton in a monograph published by the American Accounting Association reopened the controversy surrounding the entity concept. This controversy had lain dormant for a considerable time because the period of years prior to 1940 was the period of great expansion in accounting education and attention at this time was concentrated on the facts of existing practice. Paton and Littleton stated in part:

> To the stockholder who has just acquired a block of shares in a going concern with an accumulated surplus, the entire cost of the shares is capital invested. However, since the corporate balance sheet is a statement of the business entity and not of the stockholders, the reporting of accumulated surplus therein disregards the view of the incoming investor. If the corporation were viewed as merely an aggregation of individual investors, it would be consistent to hold that the earnings of the enterprise belonged to the investors from the moment of original realization. Emphasis on the entity point of view, on the other hand, requires the treatment of business earnings as the income of the enterprise itself until such time as transfer to the individual participants has been effected by dividend declaration. Between the moment when profit has been earned by the enterprise and the moment when profit-assets are distributed

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[17] Ibid.

> to investors, those who contributed capital have a claim against the assets according to their contracts. It is this claim and not profit itself that is expressed by the credit to some proprietary account.
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> That the concept of the entity is important for unincorporated as well as incorporated business should be emphasized. From the standpoint of administration it is essential that business affairs be segregated from private or personal affairs. Even if the enterprise is not a corporation, and usually powerless to hold legal title to property, accounting must regard property dedicated to business purposes as being enterprise assets. Considerations of both management and equity call for the reporting of business income, in the first instance, as enterprise earnings even if no formal legal action is needed to secure transfer to individual possession. Accounting, in a very significant sense, is institutional, with the "institution" ranging from the small store to the huge industrial corporation.[18]

Almost without exception modern day theorists use the Paton and Littleton writing as a starting point for their discussions.

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[18]William Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, (Chicago, Ill.: American Accounting Association, 1940), p. 8.

CHAPTER III

SPECIFIC AREAS OF TREATMENT OF THE ENTITY CONCEPT

This chapter will attempt to explain the treatment of specific areas which are unique to the entity concept. These areas include income, interest charges, dividends, and taxation. The discussion will also cover the entity concept with regard to consolidated statements.

Income

Robert Sprouse defines corporate income as "the maximum amount, expressed in dollars, which, if there were no additional investments during the period, could be distributed by the corporation to its beneficiaries without impairing the cumulative dollar amount of cost or other assets which were invested in the corporation at the beginning of the period."[19] A simple translation of this definition might be as follows: the amount by which the ending equity balance exceeds the beginning equity balance assuming no additional investment was made.

As was stated earlier, under the entity concept, all in-

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[19]Robert Sprouse, "The Significance of the Concept of the Corporation in Accounting Analyses," The Accounting Review, July 1957, p. 371.

come accrues to the entity and thus forms the entity's equity in itself. Revenue and expense items, therefore,should be explained in terms of enterprise asset changes rather than as increases or decreases in proprietors' or stockholders' equities. However, the entity concept does take recognition of the fact that although the entity accrues the income to itself, it does so for the "beneficiaries." Accordingly, all long-term equityholders are beneficiaries of the separate and distinct entity. This group includes bondholders, preferred stockholders, common stockholders, and all other long-term obligees.[20]

Interest Charges

In measuring the income of the corporation conceived as a separate and distinct entity existing and operating for the benefit of long-term equityholders, interest charges for long-term equtyholders, interest charges for long-term securities are not considered an expense. The proceeds from a bond issue represents an investment and a share of equity by the bondholders. Interest payments made by the corporation to the owners of said bonds constitute the distribution of their contractual share of corporate income.[21] Paton and Littleton have adopted this view:

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[20]Ibid., p. 372.

[21]Ibid.

> To management the bondholders' dollars and the money furnished by the stockholders become amalgamated in the body of resources subject to administration, and the net income of the enterprise consists of the entire amount available for apportionment among all classes of investors. Interest charges, from this standpoint, are not operating cost but represent a distribution of income, somewhat akin to dividends.[22]

Further analysis points out a very disturbing weakness in the entity concept in this regard. The treatment accorded interest charges is palatable if there is income for the period or if there is retained earnings from prior periods from which to make a distribution. If, however, there is no income to distribute, interest payments must be looked upon as a return or withdrawal of investment. But it is not a return of the bondholders' investment because their equity is not reduced by interest payments. The payment theory is assessed to the common stockholders. The inconsistency is that investment equity is withdrawn from common shareholders to be paid to the bondholders' equity interests.[23] Under these conditions it is difficult to consider the common shareholders and bondholders as being members of a single equity-holding group having common interest in the corporation.

Dividends

A "dividend" has been defined as "an appropriation of

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[22]Paton and Littleton, Corporate Accounting Standards, pp. 43-44.

[23]George Husband, "The Entity Concept in Accounting", The Accounting Review, October 1954, pp. 560-561.

current or accumulated earnings with the intent to distribute an equivalent amount of enterprise assets among the stockholders of a particular class on a pro-rata basis."[24] From the equity viewpoint, a distribution of assets which reduces the corporate entity's equity in itself (as cash dividend) or the transferring of part of the corporate entity's equity in itself to the stockholders (a stock dividend) transfers to the stockholders something which was not theirs previously and therefore constitutes income to the stockholders.

Assuming this point of view, both the cash divident and the stock dividend are income to the recipients. However, many people argue that a stock dividend is not income; they claim the stockholders are no better off after receiving the stock dividend than they were before they received it. This implies that the equity capitalized to make the stock dividend available was their equity to be capitalized. The entity concept cannot recognize this because the capitalization was of the corporations' equity in itself.

From the point of view of those who hold the proprietary concept, dividends to preferred stockholders represent charges to expense. These dividends represent payments for the use of capital supplied by the purchasers of preferred shares. The amount paid to common shareholders can only be determined after the preferred dividends are paid because it has a role

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[24]William Paton, ed., Accountants' Handbook, (New York: The Ronald Press Company, 1948), p. 1039.

in income determination. This treatment can be readily seen in the typical computations of earnings per share of common stock and book value of common stock.[25]

The entity concept as perceived so far does not consider dividend payments as compensation paid by the corporation for the use of capital invested in it. Interest payments to bondholders, dividend payments to preferred and common shareholders alike are looked upon as shares in the success of the corporate operations.

David H. Li, who is considered by many as an extreme entity theorist, takes a very unique approach to dividend treatment under the entity concept. He states that the main objective of a corporation after its inception is to survive.[26] Dividends are but a media through which the corporation's objective may be advanced by providing an attractive investment atmosphere for future financing.

He goes on to say that stockholders cannot force the corporation to pay dividends, but the corporation may, nevertheless, choose to pay dividends. Dividend deliberations are concerned not with past earnings or capital balances, but with factors relevant to the future.[27] This makes cash divi-

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[25] Sprouse, Significance of Concept, p. 376.

[26] David H. Li, "The Nature of Corporate Residual Equity Under the Entity Concept," The Accounting Review, April 1960, p. 262.

[27] Ibid.

akin to institutional advertising, a cost incurred at the discretion of the corporation with a view to the future.

It follows, then, that a cash dividend is viewed as an expense, an expense without reference to capital balances and incurred only when paid. Considered as an expense it would solve the problem of double taxation. Tax would be levied only on income after dividends-- the net income of the corporation as a separate entity.[28]

As to stock dividends, Li takes what is considered a more conventional approach. He feels that stock dividends are intended to advance the corporate objective from another direction. They are a form of recapitalization designed to promote the corporation's ability to attract additional capital by decreasing the stock price per share. A stock dividend is a discretionary action, and both the account used and the amount needed to affect the transfer are at the discretion of the corporation.[29] It follows, then that Li does not look upon stock dividends as a distribution of corporate income.

Taxation

Those who hold the entity concept feel that in measuring the income of the corporation, income taxes must be deducted. State and federal governments are not investors in the firm

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[28]David H. Li, "The Nature and Treatment of Dividends Under the Entity Concept," The Accounting Review, October 1960, p. 676.

[29]Ibid., p. 679.

and as such are not entitled to the "distribution" of income. Accordingly, the income distributed to the corporate equity-holders is clearly adversely affected by the imposing of income taxes.[30] To recapitulate, income taxes are expenses directly identified with revenues for a given period and are viewed as an unavoidable cost of doing business. Only income net of taxes, true net income, can be credited to the retained earnings account.

In reality, taxation of corporations is handled very much as described above. This brings us to another area of corporate taxation: the problem of double taxation. Many people feel that the corporate form of conducting business affairs is subjected to double taxation. First, the corporation income is taxed and then when income is distributed to the stockholder it is taxed again at the individual's tax rate. They feel this is unfair. Is it? The answer probably lies in the fact that in the eyes of many this is a penalty to be paid for having the privilege of corporate organization.

From the entity point of view, the problem of double taxation does not arise. The corporation and the stockholder are separate and distinct. It would then appear that income taxes paid by the corporation and by the corporation stockholders are income taxes paid by two separate persons. Hence, no double taxation. The fact that dividends received by share-

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[30]Sprouse, Significance of Concept, p. 374.

holders are paid out of income to the corporation is immaterial.[31] It is common that amounts paid out of one individual's income is taxable to another individual. The entity theorist could still argue that the total corporate-shareholder tax burden is too heavy but he could not base his argument on the theory of double taxation.

Consolidated Statements

Paton and Littleton state that in some instances, "a number of distinct corporations may be so closely related as to justify treatment of the group, for certain purposes, as one corporate enterprise."[32] Such is the case when one or more corporations consolidate their statements.

Consolidated statements were developed in this country to fulfill a need for meaningful statement presentation not met by single company financial statements. There are two principal methods which may be used by a parent company in accounting for its investment in the stock of a subsidiary. They are the cost method, which embodies the entity theory, and the equity method, which follows the proprietary concept.[33] From the entity viewpoint, a parent and its subsidiary are separate cor-

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[31] Husband, The Entity Concept, p. 559.

[32] Patron and Littleton, Corporate Accounting Standards, p. 9.

[33] H. Finney and Herbert Miller, Principles of Accounting-Advanced, (5th ed., Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1960), p. 320.

porate entities and the net income of the subsidiary is not the net income of the parent.

Maurice Moonitz, in a monograph published in 1951, laid down the framework for what consolidated statements are and should be within the entity concept. He states that the minority interest expresses a part of an enlarged capital rather than an accountability to an outside group that so frequently associated with the "entity theory of consolidation."[34]

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[34]Maurice Moonitz, The Entity Theory of Consolidated Statements, (Brooklyn, N. Y.: The Foundation Press, 1951), p. 85.

CHAPTER IV

THE ENTITY CONCEPT'S INTER-RELATIONSHIP WITH OTHER THEORIES

In Chapter I the idea that the accounting profession was striving to construct a general theory of accounting (one basic concept) to serve as a foundation on which to build principles and postulates was discussed. The chapter will attempt to show the efforts that have been made to reconcile the entity and proprietary concepts or at least to neutralize their emphais by placing the center of interest somewhere else.

Social Responsibilities Concept

Many people see the firm as a social institution that is operated for the benefit of all members and groups of society. They see the firm as being responsible to stockholders, management, employees, suppliers, customers, the government, and all other members of society.[35] D. R. Ladd, a leading exponent of this theory, 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. The respsibilities are a function of the

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[35]Gynther, Accounting Concepts, p. 278.

> corporations 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.[36]

Ladd is very concerned about the reporting function and strongly suggests a uniformity that will disclose the amount of information that modern corporation requires.

Suojanen sees the business unit as an "enterprise or institution with wide social responsibilities."[37] His main requirement is also the reporting function in which he would want financial statements to show "value added" as in national income accounting. He states:

> If the enterprise is considered to be an institution, its operations should be assessed in terms of its contribution ot 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.[38]

Have these two writers placed their center of interest someplace else? Yes, in the reporting function, but this does not necessarily neutralize the entity and propriety concepts. In fact, Suojanen states, "The enterprise exists apart from any of the participants."[39] Ladd appears to feel

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[36]D. R. Ladd, Contemporary Corporate Accounting and the Public, (Homewood, Ill.: R. D. Irwin, Inc., 1963), p. 13.

[37]W. O. Suojanen, "Accounting Theory and the Large Corporation," The Accounting Review, July 1954, p. 391.

[38]Ibid., p. 395.

[39]Ibid., p. 394.

the same way. Therefore, we do not have an acceptable third concept, but an elaboration of the entity concept.

The Fund Theory of Accounting

W. J. Vatter produced his fund theory of accounting in 1947 as an attempt at reconciling the entity concept and the proprietary concept.[40] Although, self-admittedly an extension of the entity concept it was designed "to emphasize even more the 'statistical' viewpoint in dealing with accounting problems."[41] Vatter 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 of 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.[42]

The fund itself (group of assets) would be increased by revenue and decreased by expenses much like the entity theorist perceives the firm.

Essentially the fund theory embraces more complete reporting. Vatter would include as much detail in the financial statements as necessary for the reader to compute the profit

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[40]William Vatter, The Fund Theory of Accounting and its Implications for Financial Reports, (Chicago, Ill.: The University of Chicago Press, 1947).

[41]William Vatter, Handbook of Modern Accounting Theory, ed. by M. Baker (Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1955), p. 367.

[42]Ibid.

figure he desires.[43] For example, the reader of the statements could take as the profit figure the one before or after deducting items for interest, income taxes, and dividends depending entirely on whether the reader perceives the entity concept or the proprietary concept.

The Commander Theory

L. Goldberg, in introducing his commander theory says:

> Neither the entity theory not 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 analyze in any way suitable for use as a basic accounting notion.[44]

Goldberg's commander theory implies that instead of focusing our attention on the separate and distinct corporation entity we should direct our attention to the human beings that control the business function. He states:

> Once the position of the commander is recognized, 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.[45]

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[43]William Vatter, The Fund Theory of Accounting, p. 36.

[44]L. Goldberg, An Inquiry into the Nature of Accounting, (Chicago, Ill.: American Accounting Association, 1965), p. 162.

[45]Ibid., p. 167.

The shortcoming of this theory can be exposed by a question. What is the point of view of the commander; is it the entity concept or the proprietary concept?

CHAPTER V

SUMMARY AND CONCLUSION

As mentioned in the opening chapter and stated again in Chapter IV, the accounting profession is striving to construct one basic concept to serve as a basis for all accounting theory.

It is the opinion of this writer that the entity theory conforms most closely with the business situation as we have it today. Prior to the growth of corporations the proprietorship view probably conformed most closely to reality. It appears that accounting procedures are in a state of transition from the proprietary view towards the entity view. This causes confusion for it precludes consistent reasoning from one accepted base.

But, is one basic concept sufficient? In our evaluation, we have to question whether it is possible to have one basic concept apply to all accounting entities. Maybe the corporation is so unlike the proprietorship that a different theory should be used. Maybe governments and non-profit organizations should have a basic concept different from a profit-making enterprise.

Most writers think not. As long as the accounting unit uses a self-balancing set of accounts (double entry) these writers feel that one concept should suffice. If this is so we should be able to accept the entity concept because it conforms most closely with economic reality. It is not nearly that easy. A person holding the proprietary concept is not going to immediately embrace the entity concept just because a theoretician advises it. It will be a long and tedious educational process before everybody will find acceptance with one basic concept.

What the theoreticians must decide on is that one basic concept. It could be the entity concept or some variation of it. It could be Vatter's fund theory or the social responsibility concept. Most likely the concept that would be most acceptable to all factions hasn't been proposed yet. But that is the point. Accounting intellectuals must take cognizance of this problem, devise an acceptable solution so that the educational process can begin.

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