Contribution of entity theory to accounting practice essay

Finance, Investment

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Entity theory was developed as a result of the inadequateness of the proprietary theory before it in explaining the treatment of a businesses assets and liabilities in relation to ownership. The proprietary theory had been developed at a time when the size of businesses was relatively small and the ownership was mainly sole proprietorship or partnerships with small number of partners. In this situation, the ownership of the business and its relationship with its creditors could not be adequately explained in accounting terms since the fact that a company is an entity separate from its owners could not be effectively disclosed under the provisions of the proprietary theory. It also did not put in consideration that owner liability in a business should be limited to the amount of capital contributed or the guarantee that an owner makes towards the settling of liabilities to any creditors the business may have in case of winding up. The limitations of the proprietary theory led to the development of the entity theory which essentially sought to make correct the shortcomings of the proprietary theory.

The entity theory as used in accounting is the proposition that an entity is a business organization formed with the intention of making profits and it is separate from its owners. The theory was developed by William Paton (1922) in his book “ Accounting Theory”. In this book, Paton proposed that the business should be treated as a separate legal entity from its owners. The economic activities of the business are therefore divorced from those of the owners of the business and thus from an accounting perspective, the commercial activities of the business will be accounted for separately from those of the owners. The theory is based on the premise of separate legal entity, and this was illustrated by the case of Salomon V. Salomon Limited where it was held that a company is a separate legal entity from its owners. It is from this that in the accounting process of a business, the assets and liabilities of the business should be made separate from the personal assets and liabilities of the owners. This implies that the owners cannot be held liable for the liabilities that the business incurs in its normal course of operations and at the same time, the business will also not be liable for any liabilities that any of the owners incurs on his personal behalf.

Entity theory as applied in accounting means that the appropriate recording and classification of transactions for future reference by the stakeholders of the business should be carried out only for the business, and the historical transactions of that are recorded by an accountant or a bookkeeper should only concern the operations of the business only as a separate legal entity. Entity theory, when applied in accounting practice implies that the records of transactions that are kept by the business should only regard the operations of the business alone. It is from this theory that the fundamental accounting equation has been developed;

Assets = Liabilities + Capital (shareholders' equity)

It is from this equation that separation of ownership from the business is derived in accounting. The creditors are considered providers of capital. However, they are treated differently from the owners who are also contributories of capital to the business. The liabilities of the business as represented by the right hand side of the equation can only be met by the use of the assets that are represented in the left hand of the equation. In accounting theory, this means that the preparation of the statement of assets and liabilities of the business should create equality between the liabilities of the business both to owners and creditors and the net assets of the business.

The accounting entity theory implies that the application of separation of the two legal entities of the owner and the business in accounting is possible for many business entities. The theory enables the separation of the business and owners in sole trading, partnerships, limited liability partnerships and limited liability companies. This makes the theory more superior to the proprietary theory which could not apply to all the business entities.

In accounting theory, there are two views of the business entity. The first view is represented by the balance sheet, and is composed of two parts, the assets and the equities. According to Paton (1922), the assets of the entity as shown in a balance sheet represent a direct statement of the value of the entity. The equities are an indirect expression of the same value. Thus according to Paton, the accounting equation should equate the total assets of the business entity with the equities in the same.

The second view of the entity is from the profit and loss statement. The profit represents the surplus gained by the business from its operations in a particular accounting period. The main aim of any business entity is the generation of profits, and the equity owners in any business have profit as their main interest in the business entity.

Contribution of entity theory in accounting practice

The entity theory has many implications which have greatly influenced the accounting practices of business entities. The theory has influenced actual accounting practices in the treatment of taxation, depreciation, goodwill, distribution of profits and valuation of the businesses assets and liabilities in its financial statements. These are explained in detail below.

Taxation is usually a mandatory contribution to the relevant authorities in which a particular business entity operates. In conformity with the requirements that a business entity be separate from its owners, the taxation of the business is carried out separately for the business and the owners (Clark 2001). The corporate tax rates are different from the personal income tax rates. The business entity pays its tax on the profits it earns before those profits are distributed to the owners. This practice is influenced by the separation principle of the entity theory, and the profits of the business entity are thus taxed before any distribution to the owners is made. The returns received by owners of the business entity in the form of dividends are also taxed as personal incomes of the respective holders of equity capital in the business entity. This practice is also based on the implications of the entity theory and in consistence with the separation principle, the dividends distributed to the owners can no longer be considered as income to the business, and this calls for their taxation as personal incomes of the owners.

The accounting treatment of the depreciation of the assets of the business entity is also based on the implied provisions of the entity theory. Depreciation provides a tax shield to the business entity. The benefits of this tax shield can only be enjoyed by the business entity alone and the owners of the business entity, according to the entity theory cannot benefit from this tax shield since they are separate legal entities despite the fact that they may have been the providers of the financing that was used to purchase those assets. Asset owned by the business owners are not depreciated to provide tax shield on the income of the owners because as separate legal entities, the owners are under different tax regulations (Riahi-Belkaoui 2004).

The treatment of goodwill in accounting practice is also informed by the principles of separate legal entities as set out by the entity theory. In the preparation of consolidated financial statements of a business entity that has acquired majority shareholding in another company, goodwill is recognized in the financial statements at its full, and the proper allocation according to the shareholding proportion that exists between the business entity as a majority shareholder and the minority shareholders is made in the consolidated financial statements. This accounting practice is based on the principles that are set out by the entity theory, and the recognition of goodwill attributable to minority shareholders in the consolidated financial statements is informed by the fact that the minority shareholders are separate legal entities from both the majority shareholders and the subsidiary business entity (Kam 1994).

The accounting practice of indicating the equity contribution of shareholders in a business entity separately from the capital contribution of other parties such as creditors is informed by the entity theory. Though creditors contribute both short term and long term capital to the business entity, they are not perceived as owners of the business and thus have no stake in the share of the after tax profits of the company. This is informed by the legal separate entity principle as set out in the entity theory. The creditors are separate legal entities from the owners and the business, and this therefore calls for the special accounting treatment of each party’s transactions with the business entity.

The accounting valuation of the business is also influenced by the entity theory. In the financial statements of a company for any particular period, the changes in the value of liabilities are not recorded but rather, only the changes in the value of the assets owned by the business entity are recorded. This accounting practice is informed by the entity theory which requires the separation of the business assets and personal assets. The creditors are treated as equities because they make capital contributions to the business just like equity shareholders and thus they should be treated as separate legal entities. This practice affects the value of the business as represented in the balance sheet and in the other financial statements (Kam 1994).

The distribution of dividends and its treatment in accounting practice to the equity shareholders is influenced by the entity theory. In some instances, the business may decide to retain part or the whole of the profits that are attributable to shareholders so as to make more investments. The goal of the owners is to maximize profits, and this practice is in contradiction to this goal. However, as separate legal entities, the owners’ decision on profit distribution is limited to their voting power.

Accounting practices that contradict principles of the entity theory

However, some of the current accounting practices are inconsistent with the provisions of the entity theory. The implications to the accounting practices that result from the entity theory are not followed comprehensively by many corporate bodies.

Creditors are considered as contributors of capital to the business as per the entity theory, and by implication should receive returns for their investment in the business entity. The returns earned by the creditors in form of interest should therefore be treated in the same manner in which the returns of the other equity owners are treated. However, this is not the case and the returns to debt holders in a business entity are treated as expense in the financial statements of the business. This treatment is inconsistent with the propositions of the entity theory. According to the accounting theory, this practice of considering the interest charges as an expense is in contradiction of the provisions of the entity theory in accounting (Godfrey, Hodgon, Holmes, & Tarca 2007)..

According to the entity theory, there should be the employment of a general price index of producers' goods. Short term creditors are contributors of short term capital to the business, and as such should have equality in the level of their earnings. However, in practice, this is not possible and the business as an entity accepts different prices from its suppliers which are not based on a general price index. This practice is inconsistent with the implied provisions of the entity theory (Kam 1994).

The above arguments show how the accounting practice in most corporate bodies in different accounting areas have been affected by the entity theory. Entity theory has therefore made a substantial contribution, if not the greatest to the current accounting practices. The principles that have been developed to govern the accounting practice in the treatment of goodwill, depreciation, valuation of assets and liabilities and taxation of the business.

References

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