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OWNERSHIP AND THE BUSINESS FIRM: IMPLICATIONS FOR CORPORATE GOVERNANCE AND SOCIAL RESPONSIBILITY

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Abstract

In the last three decades, corporate governance and reporting have been confronted to a drift toward shareholders' primacy and value, and the revival of old-fashioned proprietary views against entity views on the business firm. This paper develops an accounting perspective of the relationship between shareholding and the inner congeries of the enterprise entity. These congeries require an accounting system, instead of a market price system, to deal with. Theoretical insights and improved accounting reporting methods are then presented to better represent and control the relationship between shareholding and the business firm, based upon the distinction between shareholders' income and equity from income and equity to the enterprise entity. This distinction is especially important in case of goodwill, asset revaluations and share buybacks, as well as share issuance (use) for employee benefits and business combination considerations. Absent this distinction, accounting systems might enable corporate Ponzi schemes (through the corporate shield) by insiders (either executive management or controlling blockholders) to the detriment of other stakeholders, including outsider shareholders, and the continuity of the business enterprise over time.

KEYWORDS: theory of the firm, corporate governance, corporate social responsibility, agency theory, share buybacks, stock dividends, revaluations, goodwill, dividend policy, executive remuneration

JEL Classification Codes: M41, K22, L20, G32, G34, G35

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1. Accounting system and the theory of the firm

In this issue, both Stout and Robé refer to accounting systems as a featuring aspect of the inner working of business firms. In fact, the accounting system can be defined as the legal-economic core of the business firm, replacing and complementing the market price system in the nature and very existence of the firm from the economic viewpoint (Biondi 2005 and 2011b). This accounting core has at least two main implications for the legal-economic theory of the firm. From one side, it substitutes and expands upon the reductionist view adopted by equilibrium economic approaches. From another side, it draws upon the old-fashioned distinction between the proprietary and the entity theory of accounting.

Received equilibrium approaches maintain a definite tendency to define the business firm through a simplistic mechanics connecting the inward prices of inputs (resources) with the outward prices of outputs (products and services). Business profits are defined as the residual between these prices. If both prices are fixed on markets of reference, and those markets are efficiently competitive, the inner working of the business firm will be resolved into a straightforward connection between those market prices: the firm is then understood as a nexus of market transactions without any proper dimension or function. This appears to be, at its raw level, the meaning or at least one of the main consequences of "marginal cost pricing": to exclude or reduce any active influence of the business firm on the general equilibrium which supposedly governs the creation and allocation of resources in the overall economy. Received wisdom that competition minimizes the outward price (to the costumers) by aligning it to the sum of marginal inward prices (which remunerate various stakeholders) comes from this equilibrium preconception. Again, ideas such that business profit does not exist, or disappears in the longer-run, or corresponds with the normal (or risk-adjusted) remuneration of invested capitals, depend on this equilibrium approach to the economics of the business firm. In fact, a myriad of past and recent variants exist that base upon equilibrium, which has been largely influential on our understanding of the business firm until today. For instance, Petri and Gelfand (1979) among others show how an equilibrium approach does not completely eradicate the inner congeries of the business firm and their economic significance.

According to the institutional economic analysis developed by Biondi (2005 and 2006) and Biondi *et al.* (2007), equilibrium approaches to the business firm do daydreaming. In particular, they adopt a reductionist view that is insufficient to grasp the economy of enterprise groups which are the main phenomenon of so-called "market" economies since much longer than one century nowadays. On the contrary, equilibrium approaches may be generalized by considering the accounting system of the business firm at the core of its socio-economic working. The accounting system becomes then the institutional response to the legal-economic congeries of the business firm: It serves management and stakeholders, including shareholders, in representing, governing and controlling the special economy of the business firm fraught with layers, change, ignorance, and hazard.

Therefore, alleged outward output prices are generalized to the flow of business revenues from costumers that the accounting system defines and controls throughout the enterprise entity over time; while inward input prices become the aggregation of expenses that oppose that revenue flow to constitute the business income to the firm as represented and governed through the accounting system of that enterprise entity. In particular, this accounting system enables distinguishing between expense from expenditure by deciding whether one monetary outflow (expenditure) has to be capitalized as invested cost (acquired asset) in the asset-side of the balance sheet, or expensed out entirely among other expenses through the income statement. Moreover, this accounting system enables distinguishing revenue from financing by deciding whether one monetary inflow has to be recognized as incurred liability in the liability-side of the balance sheet, or accrued as gross income through the income statement. In sum, the ongoing articulation between funding (liabilities), invested capital (assets), and generated (gross and net) income depends on the conception (model) and functioning of the accounting system of the business firm. Nevertheless, where those invested funds come from?

2. Proprietary and entity theories of accounting

Funds invested in a business enterprise point to the liability-side of the balance sheet. Proprietary and entity theories of accounting provide a very different understanding of this side. From the proprietary perspective, the liability-side is distinguished between all debts and other future obligations held by other parties than shareholders, and the residual interests of shareholders which are then considered *as if* they were the “owners” of the business firm. On this basis, shareholders are supposed to refund those obligations through “their” gross interests (income), before having accrued and eventually shared their net interests in the business: indeed all the residual income to the firm belongs to them. From the entity perspective, shareholders provide such financing funds that are the most subordinated ones on liquidation among the overall funding. On this basis, shareholders’ funds shall be recovered and remunerated only when (and as) all the preceding funds have been so. However, this is a difference of degree, not a difference of nature among funds: the liability-side is mainly composed by different kinds of liabilities, according to the entity perspective. Therefore, shareholders’ equity constitutes a functional classification that does not acquire a different meaning for the financing of the business firm and its accounting representation.

Especially the US tradition in accounting theory has provided insightful perspectives on the institutional economics of the firm through this classic divide between entity theory and proprietary theory of accounting (Biondi and Zambon 2012). According to Gynther (1967), this divide fundamentally depends on cultural values and perceptions, more than on theoretical and heuristic insights. Accordingly, question this divide becomes a socio-economic and cultural inquiry that goes beyond matters of reason and theory. Before coming back to this philosophical position, let us delve into that divide to grasp some of its consequences and implications for an institutional economic analysis of the business firm. Gynther (1967) and Sprouse (1957) summarize the proprietary theory as follows:

> Those who hold the proprietary concept perceive the firm as being owned by a sole proprietor, a set of partners, or a number of shareholders. The firm's assets are looked upon as being the property of these people and the liabilities of the firm are their liabilities[1]. […] The proprietors are the center of interest at all times […]. [P]rofit are perceived to be the property of the proprietors (and not the firm) at the time they are earned, whether they are distributed or not. (Gynther, 1967: 275).

> According to this view, the legal entity of the corporation is merely a device of a representative nature by means of which the association's business affairs may be conveniently administered with certain legal privileges and within certain legal limitations. (Sprouse, 1957: 370).

This proprietary perspective shows important analogies with some economic theories of the firm, either Jensen and Meckling or Grossman, Hart and Moore for instance. Notions of property rights and agency relationship point to the old-fashioned "stewardship" that connects the proprietor to its agent. This approach puts one (or some completely homogeneous) *lonely entrepreneur* - who is also proprietor and manager of his business - at the core of the business firm. The latter does not acquire any functional autonomy, but is understood as a legal-economic device to run the business by (or on behalf of) that entrepreneur-proprietor. Therefore, business assets are supposed to be the proprietorship of this entrepreneur-proprietor; costs and debts consist of direct reduction of its invested wealth, while any residual income constitutes a direct increase of this proprietary wealth. In the words of Jensen and Meckling (1976: 53, note 57):

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[1] "Shareholders […] are the owners of the corporate assets and obligors of the corporate debts" (Sprouse, 1957: 370).

> […] it is somewhat misleading to speak of the owner-manager as the individual who bears the agency costs. One could argue that it is the project which bears the costs since, if it is not sufficiently profitable to cover all the costs (including the agency costs), it will not be taken. We continue to speak of the owner-manager bearing these costs to emphasize the more correct and important point that he has the incentive to reduce them because, if he does, his wealth will be increased.

Reversing the Keynes's adage,[2] some theorists, who believe themselves to be quite exempt from any practical influences, are usually the slaves of some defunct accountant. Broadly speaking, the proprietary view relates to the English classic economic view, which focused on the entrepreneur-proprietor and the accumulation of its wealth (Berle 1965). Up to the middle of nineteenth century, this economic school of thought further referred to corporate personification and stewardship: management is then mandated by the proprietor, and is accountable for its results to that proprietor through accounting reporting. In fact, Littleton (1961: 36-60) disentangled a significant conceptual advance from stewardship toward proprietorship: The latter is based on accounting for funds invested in a business affair that is then functionally distinguished from its proprietors. Some scholars also underlined the connection between proprietary theory and the socio-economic and institutional context between the first industrial revolution and the middle of nineteenth century in UK. According to McComb (1979:6):

> UK accounting theory [a kind of proprietary theory] … developed during nineteenth century in an atmosphere in which the entrepreneurial proprietor was seen as the dynamic force that made the other factors of production (land, labour, and capital) productive. In that context, accounting for the firm meant accounting to the owners or shareholders. The entrepreneur was also normally assumed to be a major provider of capital, although each role could be distinguished for purposes of economic analysis. Within that scenario, the idea that it was a function of the firm to maximize profits for its owners seemed perfectly rational, and was readily accepted.

However, in US, an explicit proprietary theory emerged at the end of nineteenth and beginning of twentieth century, and was developed by authors

2 J.-M. Keynes (1936, ch. 24, § v, p. 383): "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist." In the same place, he added that "the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."

such as Sprague and Hatfield as the second industrial revolution had been displacing those socio-economic conditions in US and elsewhere. Through a pragmatist analysis, Merino (1993) connects this late emergence to the American debate on trustification (Thorelli 1955; Hawkins 1986), especially to the divide between pragmatism and *social darwinism.*[3] At that time, US economists (including business economists), legal scholars and regulatory authorities were debating on benefits, costs and dangers of oligopolies and trusts (Cook 1893; Jenks 1900; Baker 1889; Howe 1899; Clark 1901 and 1904; Veblen 1904; Ely 1906; Bullock 1901; Meade 1903). Throughout the establishment of the Federal Trade Commission via its antecedent institutions (the Industrial Commission and the Bureau of Corporations), accounting and disclosure were central in addressing socio-economic concerns raised by the working of enterprise groups. Accounting systems were attributed with cognitive and regulatory roles, to better address determination of costs, profits and fair returns to investments, including shareholder's investments. These roles strongly influenced the eventual mandating of financial statements in the 1933 Securities Acts (Adams 1902; Stein, Radcliffe and Spence 2012).

In this context, proprietary theory of accounting tried to renew and reestablish the meaning and role of property rights and shareholding proprietors in a new context characterized by mergers and acquisitions, emerging big corporations, absentee ownership, and oligopolistic profits through active control of the price system by trusts and alliances. While proprietary theory of accounting supported the development of corporations, it also affirmed again the primacy of the proprietor and its interests (especially by rejecting retention of residual earnings and advocating dividend distribution), perhaps bringing rhetoric and confusion in the debate. However, whatever meaning and role were plaid by proprietary theory at that time, US accounting theorists did not limited themselves to reestablish old concepts and views. Since the beginning of the twentieth century, and especially after the twenties, leading scholars developed a new perspective called entity theory. According to one champion of the latter, Paton (1922, preface, p. iii):

> These doctrines of proprietorship, as propounded by Sprague, Hatfield, and others, are not entirely adequate statement of the theory of accounts under the conditions of modern business organization. The technique of accounting has developed rapidly to meet the conditions of the large-scale enterprise, but theory – as is so often the case – has lagged far behind practice.

[3] Contrary to this widespread expression, this philosophical conception should be attributed especially to H. Spencer and W.G. Sumner, whose contributions refer more directly to economy and society.

This further development somewhat relates to emergent neoclassical economics and its specific attention to the price system and the relationship between inward prices, outward prices and business profits to the firm. Among the champions of entity theory, especially W. Paton (1922: 8) adopted a neoclassical economic view:

> If the tendencies of the economic process as evidenced in market prices are to be reflected rationally in the decisions of business managers, efficient machinery for the recording and interpreting of such statistics must be available; and sound accounting scheme represents an essential part of such a mechanism… To put the matter in very general terms, accounting, insofar as it contributes to render effective the control of the price system in its direction of economic activity, contributes to general productive efficiency and has a clear-cut social significance, a value to the industrial community as a whole.

Other scholars further stressed the active management of the business processes that is required to assure this dynamic interaction between the price system and the business firm. The business firm is active and productive, but is so because it is managed and organized, not because it is "owned." Its business income generation depends, not on wealth of resources passively held (or claims on that wealth actively traded), but on the managed system dealing with *the flow of interaction and coordination* involved: that is, on dynamics and process. Stop the dynamics, and the income generation disappears. Especially another champion of entity theory, A.C. Littleton, developed an institutional economic approach surely influenced by US old institutional economics and J.R. Commons.[4] According to Littleton (1933 in 1961: 75):

> The proprietorship theory was entirely appropriate to its day. The typical enterprise was not incorporated [either sole proprietorship or partnership]; the proprietor and the business were not legally distinct [i.e., unlimited liability]. In the modern setting, "ownership" loses its force; [point *i*] the assets are corporation property; [point *ii*] ownership consists in certain rights to ultimate liquidation of prior investments and [point *iii*] of interim rights to share in enterprise earnings at the discretion of shareholder-elected directors. The entity concept is much more appropriate to twentieth century conditions.

[4] Stauss (1944) confirms this interpretation. See Biondi (2012) for further details.

In general, entity theory stresses some featuring characters of twentieth century enterprises, or at least some new features enlightened by its novel understanding of them. In particular:

1. The firm is functionally autonomous and goes on over time (going concern). This ongoing autonomy (before and unless liquidation) is recognized by law through limited liability, limited responsibility and free exit granted to shareholders; legal prior protection granted to other parties than shareholders (point *ii* above); the legal capacity to enter obligations (including autonomous property of assets, point *i* above); and the prior control on incomes and products;[5]
2. The separation between ownership, control *and* management, this latter being the only function (and role) that is allowed to dispose of assets and flows, and to organize the business;
3. The significance of "absentee ownership," implying that a large number of shareholders do not hold but an immaterial share of equity, without any significant influence on business decisions;
4. Legal restrictions on dividend distribution and capital refunding to shareholders enforced through accounting constraints (including by regulation and statutes), and the managerial right to retain net earnings (point *iii* above);
5. The fact that, before and unless liquidation, the firm must not refund shares to their value (neither market value nor book value), share-holders being obliged to sell them (including through regulated Exchanges).

A further point may be the distinction between dispersed shareholding and the minority control exerted by some shareholders and executives. Block-holding was early suggested by T. Veblen in his « depredation theory of entrepreneurial gain »,[6] pointing to block-holders' financial control on business enterprise's capitals and revenues.

Regarding the economic role of shares, entity theory recognizes them as source of financing remunerated by dividends, without direct connection to the property (or control) of assets and to the operational risks involved in this property (or control). From this perspective, Shareholders become special financiers which commit their funds through a specific class of liabilities. According to Littleton (1934: 147):

[5] See Robé (2011) and Blumberg and Strasser (2011) for further analysis and details.
[6] In Schumpeter (1954)'s words. On the myth of diffuse ownership in US and abroad, see Holderness (2009).

> What could be more logical therefore than to rest dividend law upon the profits test which would serve all parties at interest equally well? After all, those who supply the capital for modern corporations are not to be classified, as was the case long ago for single enterprises, into creditors and owners each with its different legal status. They are all suppliers of capital and they are all claimants against earnings and residual assets according to the terms of their respective contracts. They have more common than antagonistic interests.

In this way, entity theory moves the accounting basis from the balance sheet as a collection of properties, obligations and claims, towards financial and economic flows which are expected to be more useful and reliable to grasp the inner congeries of enterprise groups over time. According to Raby (1959: 453, italics in original) among others,[7] the notion of enterprise entity is then at the centre of the accounting system:

> An *economic* entity, then, is an aggregate of assets, directed by human intelligence and effort, committed to, and engaged in, an economic undertaking. By assets we mean property and rights on property, whether real or personal, tangible or intangible. *Economic activity* is carried on through the medium of *transactions*, which are exchanges of goods and/or services for a consideration. By an *economic undertaking*, we mean the application of assets, in combination with human intelligence and effort, towards the consummation of transactions that are related in terms of contributing to a common objective.

Surely influenced by Littleton and the German tradition of accounting thought (Biondi 2012; Biondi et Zambon 2012), Raby explicitly adopts transactions as the fundamental unit of analysis, and defines the nature of the business entity as “a pattern of relationships (of assets to assets, of assets to sources of assets, of assets to claims against assets, of assets to people, of people to people, etc.)” (*ibidem*). From this dynamic perspective, the entity cannot exist but as a « going concern »:[8]

[7] W. W. Suojanen (1954 and 1958) developed an *enterprise theory* with an explicit institutional perspective that was supposed to overcome both proprietary and entity theories. In fact, he misunderstood entity theory as the personification of the firm. In our opinion, Suojanen’s theory can be considered as an entity-based approach. He defined revenue as value added, centered on production instead than sales to customers.

[8] Biondi (2005) expands upon this concept to “becoming concern”, in order to stress its dynamic nature.

> […] the entity is real, is something greater than merely the sum of its parts. [Any of the individual parts can be, and in time will be, changed or replaced, and yet (the firm) will go on without interruption and without abrupt change in basic characteristics]. It is the combination of the parts in such a manner as to give the parts purpose and meaning, and thereby it transforms the parts and makes them components of a whole. (Raby, 1959: 452).

Shareholders play here their role as one of the sources of financing. Their shares grant them with some rights to dividends subordinated to Board decision, as well as some ratification rights on specific business events, in the same vein as other securities grant rights in different ways and circumstances to their holders. According to Littleton, Raby or Scott (1979) among others, ownership has no longer a featuring meaning and role in this context:

> Thus, in an undertaking of any size or complexity, the entity is not, as we so often seem to assume, merely an "agent" for the stockholders. From the transaction viewpoint, on the contrary, no one "owns" an economic entity. Instead of owners, there are various sources of entity assets, there are various persons who are party to different types of related transactions with the entity. (Raby, 1959: 454).

Regarding the accounting representation, a flow basis is usually preferred. Accordingly, business transactions involving the entity in the business cycles of production and sale can (and have to) be distinguished between transactions concerning costs, and transactions concerning revenues.[9] Among others, Raby (1959) recognizes the economic specificity of the enterprise entity that can be and should be represented without referring to market values. The purpose and scope of accounting system is then to represent, not to value, the business firm:[10]

> What the entity does have is a need for some technique that can be used for keeping track of the complex relationships that are its essence. To do this job, it uses money as a symbol ("in terms of money"). Money is a symbol of the consideration involved in a particular transaction. […]
> Recording of transaction in terms of money is, then, a convention of symbolic representation, and not basically a valuation method at all. The monetary convention is a logical, but not necessarily inevitable, method of solving the problem of

[9] "(2) transactions with, directly or indirectly, the consumers of the entity's goods or services" (*ibidem*, p. 454b).

[10] On this matter, see also Littleton (1961), *Symbols of Reality*, pp. 226-227.

> trying to keep track of relationships which are fundamentally not homogeneous, in an objective and understandable manner. It is a by-product of the existence of the entity as a going concern. And thus only where the objective of the entity is liquidation must the symbolic representation logically be in terms of realizable value. (Raby, 1959: 453-454).

> The language of accounting involves the use of money as a symbol. By contrast, the language of trade involves the use of money as a medium of exchange. […] From the viewpoint of the entity, which is the viewpoint embodied in the accounts, accounting presents no questions of valuation, of worth. Money is only a symbol. From the viewpoint of persons dealing with the entity, money is not a symbol only, but is a medium of exchange and a measure of worth. (*ibidem*: 456 and 460).

The economic activity of the business firm surely involves transactions with its stakeholders. These transactions may involve considerations that are settled at market prices at some point of time. Nevertheless, this outer process of exchange does not resolve the inner economic core constituted by the ongoing business enterprise. From one hand, not all those transactions are market-based. From another hand, combinations and events occur that feature the business activity beyond that exchange process. The outer price system is then unable to account for the whole business activity: The accounting system replaces and complements that price system in representing, organizing and governing the business entity over space and time (Biondi 2005 and 2010).

Entity theory often refers to the business entity as a socio-economic institution, and bases the theory of the firm on the active management of this autonomous socio-economic system (Gruchy 1947). The holistic and dynamic nature of the firm is explicitly considered, as well as the coexistence of various interests that are both joint and conflicting in its common field. Entity theory appears to broadly agree with the following persuasion argued by J. M. Keynes and concerned with what he claimed “the end of the *Laissez-Faire*”:

> A point arrives in the growth of a big institution … at which the owners of the capital, i.e. the shareholders, are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of great profit becomes quite secondary. When this stage is reached, the general stability and reputation of the institutions are more considered by the management than the maximum of profit for the shareholders. The shareholders must be satisfied by conventionally adequate dividends, but one this is secured, the

> direct interest of the management often consists in avoiding criticism from the public and from the customers of the concern. This is particularly true if their great size or semi-monopolistic position renders them conspicuous in the public eye and vulnerable to public attack.
> (J.M. Keynes, *The End of Laissez-Faire*, 1926 in *Essays in Persuasion*, Harcourt, Brace and Co., NY 1932, pp. 314-315).

From the entity perspective, the income to the firm bases upon the ongoing allocation of flows among all the claimants, including shareholders, executive management, employees, creditors, but also government, in different ways. In particular, Paton defines a specific class of business income - called “net operating income,” pointing to the business role as a productive unit that generates income from revenues from sales to the costumers. “Net operating income” consists of generated income after having paid salaries and employee benefits. This income is then available for “distributions of net revenue” to all the classes of financing (long-term credit, share, bonds) and taxes. On this basis, accounting systems report on the capacity of the business firm and its management to organize and combine production in an efficient and effective way over time.

In conclusion, the last three decades have factually assisted to a revival of old-fashioned proprietary views against entity views on the business firm. We can concede then to Gynther (1967) that problems of institutions must ultimately dissolve into a study of history and philosophy, renouncing to understand the historical evolution of ideas in terms of cumulative progress. Indeed property and entity are ideas that are embedded in different epochs and spirits of capitalism. In various epochs, their ideological dialectics has been refreshed as long as previous debates were forgotten and renewed in theoretical and applied arenas, often under the pressure of major changes and events. No theory has won yet from the historical viewpoint. Nevertheless, entity theory enables capturing some featuring characters of enterprise groups as they work and are managed since more than one century now. Current economic theories of the firm do not address the holistic and dynamic features of these groups, even though some of those theories struggle to distinguish the firm from the market as alternative and complementary modes of economic organization. The entity theory points to management and the accounting system to complete the dynamic system generated by the becoming economic organization of the firm: Management, accounting system and the organization together define the economic nature and very existence of the firm as an enterprise entity. Its existence (and essence) depends on the working of its accounting system. The nature of the firm, therefore, relates to the nature of the accounting system, rather than to ownership or the market (the pricing system). This holistic and dynamic perspective may help better understanding the current state of institutional affairs concerning the business firm regarding corporate governance and reporting (Biondi 2009 and 2011b).

3. Accounting for shareholders' claims: Implications for corporate governance and reporting

The present state of institutional affairs concerning the business firm is ambiguous. The rise of shareholders primacy and value has surely driven a coming-back of proprietary views on corporate governance and reporting. Even the critique of this revival is sometime framed into the same worldview: some argue for managers to act as "trustees," or corporations to become good "citizens," while these latter notions refer respectively to the business firm as a financial trust to be managed on behalf of its owners, and to the personification of the legal entity that makes it insulated from social control of business (Biondi 2011b). Both notions somewhat maintain and actually reinforce shareholders primacy, instead of developing alternative perspectives.

At the same time, the inner congeries of the business firm have not renounced to confront its alleged proprietors with change, ignorance and hazard. Among others, recent dramatic scandals and financial shortcomings in corporate affairs were provoked by the inability of those proprietary views to assure investor protection in the context of twentieth-first century enterprise groups. As a matter of fact, entity theories were developed to better represent, control and govern the business firm even from the shareholders' viewpoint. The proprietary approach might be useful if only one proprietor runs the business. Even so, it would be confounding, for that proprietor and his creditors, to mingle personal and business equities in one unique account. Especially under limited liability and the so-called corporate shield, delegated management, and complex organization (points 1-3 above), it deems to be useful to keep the funded investment and its result over time distinct, for matters of governance and control. Furthermore, when multiple proprietors exist across space and over time, allocation problems may occur that deserve proper accounting representation (point 4 above), especially to avoid corporate Ponzi schemes accomplished through the accounting system of the business entity. In one phrase, the joint and temporal dimension of the business firm, that is, its collective and dynamic economic nature, enters the scene and shall be accounted for.

Regarding current business practices, the cases of employee benefits and business combinations paid out through share consideration are material and significant of this accounting need. Many argue for potential shortcomings and lack of transparency in those cases; better disclosure has been advocated and also enforced to improve corporate governance and control on these matters. At the same time, their financial consequences on the economy and finances of the business firm have received less attention.

Both matters may be better accounted for through a clear representation of the relationship between the business entity and its shareholding. This representation still lacks in current accounting systems. At some point in history, a statement of shareholders equity changes has been introduced to clarify shareholders' equity movements within the period of reference and between periods, but this form is no longer adapted to serve current purpose and scope of corporate governance and control. This section aims to fill in this gap by providing a heuristic understanding of this relationship, drawing upon the works of Anthony (adopting an entity approach) and Staubus (adopting a proprietary approach).

Shleifer and Vishny (1997: 737) state that "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". The authors surely imply either a market return, or a comprehensive return adding dividends to the variation of share market prices. However, as explained above, the market value is external to the enterprise process (point 5 above), while the distribution of dividends is residual and constrained by figures and covenants established through the accounting system (point 4 above). In this context, corporate governance may be better assisted by an accounting model and standard (that is, an accounting system) that defines shareholders' return by reference to the inner congeries of the business firm. From this perspective, corporate governance and financial accounting point to the business entity process that allocates income to the firm between shareholders, other stakeholders, and the continuity of the business enterprise over time.

From the enterprise entity viewpoint,[11] shareholders' equity constitutes a special source of financing. According to Schumpeter (1926, as translated by Biondi 2008: 540-41):

> From the economic viewpoint, the 'capital' of a firm is as much a liability as all the other debts, from preference bonds, to daily debt, to the 'use of balances over night' [in English in the original]. The role of these cash amounts is no different from the role of 'capital' in the suggested meaning as provider of means of production. Thus, we can call capital the adding-together of all the items on the liability side. Accounting practice leads us to this interpretation by teaching us both that the practical notion of capital is too narrow, and that it is only

[11] Some proprietary theorists concede to adopt some entity convention for sake of representation and control.

> for practical reasons that amounts that are similar to capital by role and nature are excluded. To be clear, the distinction between the different items constituting the whole amount committed to the firm is fundamental for such practical matters as understanding the situation of a business activity [*Unternehmen*], but is secondary from the theoretical viewpoint we are examining. If we wish to fit the notion of capital with the point that constitutes the core of the phenomenon called capitalism (as all the theories of capital - more or less explicitly - wish to do), we need to enlarge this notion in this way towards its accounting extent.

As a consequence, the accounting system may recognize shareholders' claim on the business income generated by the enterprise entity as a cost and an allocation. To better account for this relationship between the entity and shareholding, two main distinctions shall be introduced: the first distinction concerns the remuneration granted to shareholders on the basis of the funds that they have committed to the entity in the past. "Shareholders' equity interest" is then distinguished from "residual earnings to the entity". The second distinction concerns the separation between cumulated "shareholders' equity" and the remaining "entity equity," as one main source of both equities comes evidently from the accumulation of respectively "shareholders' equity interest" and "residual earnings to the entity" over time. From a functional viewpoint, shareholders' equity contains all the residual interests accrued to shareholders: It accounts for their outstanding claims against the business firm. In turn, the entity equity contains special equities that have accrued, temporarily or indefinitely, to the business firm.

Let consider two methods to functionally split current earnings between shareholders and the enterprise entity. One method consists in computing an explicit shareholders' equity interest on shareholders' funds committed in the past. The latter is taken away from earnings and allocated to shareholders' equity, while compensated with distributed dividends. The next shareholders' equity interest will be then computed on the updated net capital basis. If (and as) earnings are insufficient to cover it, that interest may be capitalized in order to be paid in the future (or taken away from previously cumulated entity equity, if the latter is distributable). As show numerical examples in Appendix I, this method insulates shareholders' remuneration from the dynamics of the business income, as is the case for bondholders and bank debts in current corporate practices. As long as the firm goes on and is not confronted to distressed financial conditions, the remuneration of shareholders remains fixed at shareholders equity interest. Nevertheless, this accounting method makes the business decision on their remuneration explicit, further facilitating the monitoring of the extraction of shareholders interest from income and equity to the business firm. It is surely valuable to remember here that shareholders' equity interest constitutes one of the main components (together with corporate bonds and bank debts) of the "cost of capital" that the financial system is supposed to minimize from the macroeconomic viewpoint. This computed shareholders' equity interest is also consistent with current capital budgeting and management accounting systems.

Alternatively, a share of current earnings (be they positive or negative) may be allocated to shareholders' equity, while the remaining part accrues to the entity equity. Appendix I shows some variants of this method, according to the sharing rules settled between the entity and shareholders. In particular, the latter may: be shielded from losses (which are then taken entirely on the entity equity); share a fair share of them; or bear the entire loss burden. The loss share allocated to shareholders relates to the relative degree of securitization of other interests than shareholders' interests in income allocation. Some jurisdictions did enforce similar rules, or still do today. Shareholders' dividends and share buybacks should be constrained by and limited to the net accrued shareholders' equity after allocated losses. In the past, an obligation to reintegrate shareholders' funds (which were initially or progressively committed to shareholders equity) against incurred losses was adopted by some jurisdictions, even though it does not seem significant in current corporate practices (contrary to margin calls applied in financial intermediation practices).

Concerning the balance sheet, the relationship between shareholding and the entity implies distinguishing cumulated shareholders' equity, which comprises committed funds and successively accrued shareholders' earnings, from cumulated entity equity. Prudential reserves and other non-distributable reserves are natural candidates for allocation into the entity equity in this reshaped balance sheet form.

The functional distinction between shareholders' and entity equity is also important when revaluation reserves and goodwill are considered. Revaluation and goodwill are capitalized to the balance sheet on the asset side, but depend on expectations and estimations of current value that is not yet accrued and then distributable from the enterprise entity viewpoint. Under currently adopted accounting standards in US and Europe, revaluation and goodwill are included in comprehensive income (which points to changes of value), not income (that is earned revenue). Therefore, corresponding reserves on the liability side should be included in the entity equity, to make transparent that they are not yet earned and cannot be normally distributed to shareholders. If this precaution is not respected, a corporate Ponzi scheme[12] among different cohorts of shareholders (or between

[12] Here, Ponzi scheme means a financial design where someone's interest is paid out from someone else's capital. In the classic Ponzi scheme, screwed capital provider had committed its capital that is inappropriately used to pay out interests. In this case, the incurred loss is held by

shareholders and other stakeholders, or between shareholders and executive management) might occur: The entity may distribute to current shareholders (or other recipients) windfall gains from revaluation and goodwill. The latter gains are still uncertain and conditional: they have not yet been secured throughout the business income generation process, and may then disappear in the future, leaving future shareholders (and future stakeholders) with the actual bill (incurred to paid out those windfall gains) to be recovered. A functional distinction between shareholders' equity and entity equity enables *disclosing* this matter, helping investors and other stakeholders to *control* it and then better *govern* the related events and their impact on the business firm. Appendix II shows a simple case of windfall gains on asset revaluation on period 5 which disappear on period 7. If those gains were not taken apart in the entity equity throughout those periods (as showed by Appendix II), they might have been distributed to current shareholders (or executive management) on periods 5 and 6, to the detriment of shareholders, other stakeholders and the continuity of the enterprise entity in subsequent periods. Their distinction from earnings earned to shareholders is also important to maintain reasonable (and fair) claims of shareholders' return. If those gains were not taken apart, shareholders might have required a higher part of current earnings to target the same level of Return on shareholders' Equity (ROE) throughout periods 5 and 6.

Furthermore, the functional distinction between shareholders' equity and enterprise entity equity is significant when (and as) shares are issued by inclusion of outstanding reserves into shareholders' equity (so-called stock dividends), or are issued (bought back) at premium or discount. Conditional reserves that are not earned to shareholders should not be eligible to stock dividends. Concerning share repurchasing, this kind of financial operations became widespread in the last decades.[13] According to Baker *et al.* (2011, chapter 7), repurchase payouts was between 10% and 20% (as a % of Income before Extraordinary Items) for the S&P500 sample during the nineties, became stably over 30% after 1998, with an hugely increasing trend to over 60% up to 2007 (becoming largely superior to dividend payouts on the same period). Nowadays, management normally buyback shares to complement dividend distribution and manage the share market prices (De Cesari *et al.* 2011); furthermore, issuances are accomplished at premium or

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those stake-holders which go on holding their stakes after the interest's payment, and should then bear the incurred loss for it. For instance, if executive management pays out its benefits from shareholders' equity (not on earned income to the firm), a Ponzi scheme will be accomplished to the detriment of current shareholders.

[13] Peterson and Hawker (1998) review US recent national legal capital restrictions on stock distributions and provided some empirical evidence of their effect. Hachiya (2010) reviews Japanese recent national case and provided some empirical evidence of Japanese practices. Siems and De Cesari (2012) review rules and practices from some European countries under European Union framework.

discount according to share market and other contextual conditions. Issuances are especially significant for both employee benefits (stock options), and business combinations (mergers and acquisitions). In the latter case, issued shares are then exchanged against the acquired business, generally against shares on the controlling legal entity of it. In all these cases, the functional distinction between shareholders' and entity equities may assist investors and other stakeholders in controlling and governing how management deals with interests held by actual and incipient shareholders, other stakeholders and the continuity of the enterprise entity over time.

From a proprietary accounting perspective, entity earnings and related entity equity are only temporarily allocated to the business firm and shall eventually come back to shareholders that are the ultimate residual claimants of all the earned earnings. From an entity accounting perspective, however, this distinction points to the fundamental distinction between the firm and its shareholders: net earnings to the entity (both current and accrued) are then available to be invested in the business, or eventually distributed to other recipients than shareholders. The economic responsibility of business is then expanded beyond "increase shareholders' wealth" since its accounting representation.

Summary and conclusion

In the last three decades, corporate governance and reporting have been confronted to a drift toward shareholders' primacy and value, and the revival of old-fashioned proprietary views against entity views on the business firm. This paper has developed an accounting perspective of the relationship between shareholding and the inner congeries of the enterprise entity. These congeries require an accounting system, instead of a market price system, to deal with. Improved accounting reporting methods were suggested to better represent and control the relationship between shareholders and the business firm, based upon the distinction between shareholders' income and equity from income and equity to the enterprise entity.

Appendix I – The relationship between shareholding and the firm: accounting representations

Let assume one simple enterprise entity that is initially funded by financing shareholders to acquire one single productive asset having an indefinite useful life, for 10 monetary units. The entity is expected to generate variable current earnings over time that shall be allocated to shareholding and the entity throughout the accounting periods of reference (10, for sake of simplicity). Heuristic income statements and balance sheets are provided according to various accounting methods to account for this allocation. For sake of simplicity, dividend distribution is ignored.

First accounting method: shareholders' equity interest

	Start-up	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
INCOME STATEMENT											
Current Earnings		**4,52**	**3,58**	**2,16**	**-0,20**	**4,43**	**-0,12**	**3,54**	**4,62**	**0,61**	**2,49**
Shareholders Equity interest at 8.4% [A]		0,84	0,91	0,99	1,07	1,16	1,26	1,36	1,48	1,60	1,74
Residual earnings to the Entity		3,68	2,67	1,17	-1,27	3,27	-1,38	2,18	3,14	-0,99	0,75
BALANCE SHEET											
Asset (indefinite life)	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00
Cash Account – Initial balance		0,00	4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14
Change in Cash		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance		4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14	25,63
TOTAL ASSETS	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Shareholders' equity – Initial Balance [B]	0	10,00	10,84	11,75	12,74	13,81	14,97	16,22	17,59	19,06	20,67
Change	10,00	0,84	0,91	0,99	1,07	1,16	1,26	1,36	1,48	1,60	1,74
Final balance	10,00	10,84	11,75	12,74	13,81	14,97	16,22	17,59	19,06	20,67	22,40
Entity Equity – Initial balance		0,00	3,68	6,35	7,52	6,25	9,52	8,15	10,32	13,47	12,47
Change		3,68	2,67	1,17	-1,27	3,27	-1,38	2,18	3,14	-0,99	0,75
Final balance		3,68	6,35	7,52	6,25	9,52	8,15	10,32	13,47	12,47	13,23
TOTAL LIABILITIES	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Return on Shareholders' Equity (ROE) [A/B]		8,4%	8,4%	8,4%	8,4%	8,4%	8,4%	8,4%	8,4%	8,4%	8,4%

According to this method, shareholders' equity interest is computed as a cost at a fixed interest rate (8.4% in the numerical sample).

Second accounting method: earnings sharing (proportional in profits and losses)

	Start-up	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
INCOME STATEMENT											
Current Earnings		**4,52**	**3,58**	**2,16**	**-0,20**	**4,43**	**-0,12**	**3,54**	**4,62**	**0,61**	**2,49**
Shareholders Equity Share [A]		2,26	1,79	1,08	-0,10	2,22	-0,06	1,77	2,31	0,31	1,25
Residual earnings to the Entity		2,26	1,79	1,08	-0,10	2,22	-0,06	1,77	2,31	0,31	1,25
BALANCE SHEET											
Asset (indefinite life)	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00
Cash Account – Initial balance		0,00	4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14
Change in Cash		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance		4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14	25,63
TOTAL ASSETS	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Shareholders' equity – Initial Balance [B]	0	10,00	12,26	14,05	15,13	15,03	17,25	17,19	18,96	21,27	21,57
Change	10,00	2,26	1,79	1,08	-0,10	2,22	-0,06	1,77	2,31	0,31	1,25
Final balance	10,00	12,26	14,05	15,13	15,03	17,25	17,19	18,96	21,27	21,57	22,82
Entity Equity – Initial balance		0,00	2,26	4,05	5,13	5,03	7,25	7,19	8,96	11,27	11,57
Change		2,26	1,79	1,08	-0,10	2,22	-0,06	1,77	2,31	0,31	1,25
Final balance		2,26	4,05	5,13	5,03	7,25	7,19	8,96	11,27	11,57	12,82
TOTAL LIABILITIES	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Return on Shareholders' Equity (ROE) [A/B]		22,6%	14,6%	7,7%	-0,7%	14,7%	-0,3%	10,3%	12,2%	1,4%	5,8%

According to this method, current earnings are split among shareholding and the entity in the same proportion (50%) for profits and losses over time.

Earnings sharing (shareholders' full bearing of losses and proportional bearing of profits)

	Start-up	1	2	3	4	5	6	7	8	9	10
INCOME STATEMENT											
Current Earnings		4,52	3,58	2,16	- 0,20	4,43	- 0,12	3,54	4,62	0,61	2,49
Shareholders Equity interest [A]		2,26	1,79	1,08	-0,20	2,22	-0,12	1,77	2,31	0,31	1,25
Residual earnings to the Entity		2,26	1,79	1,08	0,00	2,22	0,00	1,77	2,31	0,31	1,25
BALANCE SHEET											
Asset (indefinite life)	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00
Cash Account – Initial balance		0,00	4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14
Change in Cash		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance		4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14	25,63
TOTAL ASSETS	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Shareholders' equity – Initial Balance [B]	0	10,00	12,26	14,05	15,13	14,93	17,15	17,03	18,80	21,11	21,41
Change	10,0	2,26	1,79	1,08	-0,20	2,22	-0,12	1,77	2,31	0,31	1,25
Final balance	10,00	12,26	14,05	15,13	14,93	17,15	17,03	18,80	21,11	21,41	22,66
Entity Equity – Initial balance		0,00	2,26	4,05	5,13	5,13	7,35	7,35	9,12	11,43	11,73
Change		2,26	1,79	1,08	0,00	2,22	0,00	1,77	2,31	0,31	1,25
Final balance		2,26	4,05	5,13	5,13	7,35	7,35	9,12	11,43	11,73	12,98
TOTAL LIABILITIES	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Return on Shareholders' Equity (ROE) [A/B]		22,6%	14,6%	7,7%	-1,3%	14,8%	-0,7%	10,4%	12,3%	1,5%	5,8%

According to this method, current earnings are split among shareholding and the entity in the same proportion (50%) for profits, while shareholders bear the whole amount of incurred losses.

Earnings sharing (shareholders' shield from losses, proportional bearing of profits)

	Start-up	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
INCOME STATEMENT											
Current Earnings		4,52	3,58	2,16	- 0,20	4,43	- 0,12	3,54	4,62	0,61	2,49
Shareholders Equity interest [A]		2,26	1,79	1,08	0,00	2,22	0,00	1,77	2,31	0,31	1,25
Residual earnings to the Entity		2,26	1,79	1,08	-0,20	2,22	-0,12	1,77	2,31	0,31	1,25
BALANCE SHEET											
Asset (indefinite life)	10,0	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00	10,00
Cash Account – Initial balance		0,00	4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14
Change in Cash		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance		4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14	25,63
TOTAL ASSETS	10,0	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Shareholders' equity – Initial Balance [B]	0	10,00	12,26	14,05	15,13	15,13	17,35	17,35	19,12	21,43	21,73
Change	10,0	2,26	1,79	1,08	0,00	2,22	0,00	1,77	2,31	0,31	1,25
Final balance	10,0	12,26	14,05	15,13	15,13	17,35	17,35	19,12	21,43	21,73	22,98
Entity Equity – Initial balance		0,00	2,26	4,05	5,13	4,93	7,15	7,03	8,80	11,11	11,41
Change		2,26	1,79	1,08	-0,20	2,22	-0,12	1,77	2,31	0,31	1,25
Final balance		2,26	4,05	5,13	4,93	7,15	7,03	8,80	11,11	11,41	12,66
TOTAL LIABILITIES	10,0	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Return on Shareholders' Equity (ROE) [A/B]		22,6%	14,6%	7,7%	0,0%	14,6%	0,0%	10,2%	12,1%	1,4%	5,7%

According to this method, current earnings are split among shareholding and the entity in the same proportion (50%) for profits, while shareholders are entirely shielded from incurred losses.

Appendix II – Accounting reporting of windfall gains from asset revaluation

In this numerical example, the same firm as Appendix I is submitted to an asset upward revaluation of 20 monetary unit in period No. 5. This revaluation is subsequently written off in period No. 7. The separation of shareholders' income and equity respectively from entity income and equity prevents the distribution of an estimated windfall gain that was not earned.

	Start-up	1	2	3	4	5	6	7	8	9	10
INCOME STATEMENT											
Current Earnings		**4,52**	**3,58**	**2,16**	**- 0,20**	**4,43**	**- 0,12**	**3,54**	**4,62**	**0,61**	**2,49**
Shareholders Equity interest [A]		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Residual earnings to the Entity		-	-	-	-	-	-	-	-	-	-
BALANCE SHEET											
Asset (indefinite life)	10,00	10,00	10,00	10,00	10,00	30,00	30,00	10,00	10,00	10,00	10,00
Cash Account – Initial balance		0	4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14
Change in Cash		4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance		4,52	8,10	10,26	10,06	14,49	14,37	17,91	22,53	23,14	25,63
TOTAL ASSETS	10,00	14,52	18,10	20,26	20,06	44,49	44,37	27,91	32,53	33,14	35,63
Shareholders' equity – Initial Balance [B]	0	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14
Change	10,0	4,52	3,58	2,16	-0,20	4,43	-0,12	3,54	4,62	0,61	2,49
Final balance	10,00	14,52	18,10	20,26	20,06	24,49	24,37	27,91	32,53	33,14	35,63
Entity Equity – Initial balance		-	-	-	-		20,00	20,00	-	-	-
Change		-	-	-	-	20,00	-	-20,00	-	-	-
Final balance		-	-	-	-	20,00	20,00	-	-	-	-
TOTAL LIABILITIES	10,00	14,52	18,10	20,26	20,06	44,49	44,37	27,91	32,53	33,14	35,63
		-	-	-	-	-	-	-	-	-	-
Return on Shareholders' Equity		45,2%	24,7%	11,9%	-1,0%	22,1%	-0,5%	14,5%	16,6%	1,9%	7,5%

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