THE CONCEPTUAL DISTINCTION BETWEEN LIABILITIES AND EQUITY: A NEW APPROACH REQUIRED

A thesis

submitted in partial fulfilment

of the requirements for the degree of

Master of Commerce

by

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University of Canterbury 1998

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ABSTRACT

This thesis examines the conceptual distinction between liabilities and equity, in the context of business entities, by means of a literature review. It is shown that the conceptual distinction between liabilities and equity requires consideration of the underlying equity theory. Various equity theories are compared, including the entity, proprietary and residual equity theories, which each view liabilities and equity, and the distinction between the two, differently. In addition to these well-known equity theories, another equity theory is presented, that has received little specific attention as an equity theory in the literature, but nevertheless appears to have considerable support. This other theory is termed the non-compulsion equity theory for the purposes of this thesis. Despite the support from the accounting literature, it is shown that the non-compulsion equity theory appears to have little support from either the law or the economics literature. Given that accounting takes place in the wider legal and economic environment, this suggests that the non-compulsion equity theory may not be an appropriate basis for distinguishing between liabilities and equity. A review of the accounting conceptual statements reveals that they are inconsistent in their application of an underlying equity theory, because they use several equity theories rather than one, including the non-compulsion equity theory, which is adopted by the conceptual statements' definitions of liabilities and equity. A closer examination of the non-compulsion equity theory demonstrates that it is based upon inconsistent reasoning and questionable assumptions, suggesting that it is fundamentally flawed. This thesis concludes by rejecting the non-compulsion equity theory as a basis for distinguishing between liabilities and equity, suggesting that a new approach is required. The residual equity theory seems likely to provide a suitable alternative.

CHAPTER ONE
INTRODUCTION

1.1 Introduction

Many national accounting bodies, and the International Accounting Standards Committee, have issued accounting conceptual statements. These conceptual statements are intended to provide guidance to standard setters when formulating or revising accounting standards, and to accounting practitioners when preparing, reviewing or auditing financial statements (IASC 1989). The Institute of Chartered Accountants of New Zealand (ICANZ), for example, is currently engaged in revising all existing standards for consistency, wherever possible, with its conceptual statement. It appears, therefore, that these conceptual statements will shape future accounting practice.

All of these conceptual statements contain similar definitions of three financial elements that are used to classify information presented in the statement of financial position: assets, liabilities and equity. The definition of assets and liabilities are given first, then equity is defined as the residual interest in the entity's assets after deducting its liabilities (ICANZ SOC 7.15, FASB SFAC6 49, AARF/AASB SAC4 78, IASC Framework 49(c)). This approach to liabilities and equity implies that they are mutually exclusive interests in the assets of the entity (AARF/AASB SAC4 82, FASB SFAC6 54). It also means that the two categories of financial interests are exhaustive: any financial interest that does not meet the definition of a liability is automatically included in equity.

The distinction between liabilities and equity is of considerable importance. The distinction impacts upon the entity's reported financial position. For example, the

classification of a particular financial interest affects the reported individual totals of liabilities and equity, and financial ratios based upon those amounts, such as the debt to equity ratio (FASB 1990). Westwood (1995), in a discussion of creative accounting, noted that the reclassification of debt as equity "can enhance investment attraction of the company, as well as enabling breaches of solvency and gearing provisions in debenture trust deeds to be avoided" (12).

Distinguishing between liabilities and equity has been made more difficult by the development of hybrid financial instruments, which have characteristics of both debt and equity. The difficulty of classifying such instruments creates opportunities to manipulate accounting information (Whittred et al. 1996).

Given the importance of the distinction between liabilities and equity, and the classification problems associated with hybrid financial instruments, a review of the basis for distinguishing between liabilities and equity is appropriate. One might expect that the conceptual distinction between liabilities and equity is already established in the accounting conceptual statements, given that the purpose of these conceptual statements is to set out the concepts that underlie the preparation of general purpose financial reports (ICANZ SOC 1.2, AASB/PSASB PS5 3, FASB SFAC1 3). It seems, however, that the conceptual distinction between liabilities and equity is not firmly established by the conceptual statements. For example, in the United States of America, the Financial Accounting Standards Board (FASB) issued a discussion memorandum on issues relating to distinguishing between liability and equity instruments, and accounting for hybrid financial instruments (FASB 1990). This discussion memorandum raised a number of questions, including how the current conceptual definitions of liabilities and equity are to be interpreted and applied to specific financial instruments; whether the present line between liabilities and equity should be moved; whether equity should be defined

independently of liabilities and assets instead of as a residual, and, if so, how it should be defined; whether a third "capital" element should be added to deal with hybrid financial instruments; and whether the present distinction between liabilities and equity should be effectively eliminated. It appears, therefore, that fundamental questions exist concerning the conceptual distinction between liabilities and equity. It is hoped that this thesis will contribute towards finding an answer to these questions.

The first part of this thesis, chapters two to four, outline the research question and method. Chapter two considers the importance of the distinction between liabilities and equity, for example, for financial ratio analysis and debt covenant purposes. Chapter three discusses how this distinction has been blurred by hybrid financial instruments, and gives examples of such instruments. Chapter four explains the focus of this research, the basic and supplementary research questions, and the method by which this research was conducted.

Chapters five and six of the thesis reviews accounting literature. Chapter five compares various equity theories, including the view of each theory regarding the nature of "liabilities", "equity", and the distinction between them. From this review an initial equity theories framework is developed. Chapter six then examines the discussion of liabilities and equity by prominent accounting authors, comparing their discussion to the various equity theories. This examination reveals a further equity theory, termed the non-compulsion equity theory for the purposes of this work, which appears to have considerable support from the accounting literature. Accordingly, the initial equity theories framework is modified to include this equity theory.

The equity theories framework is used as a point of reference in the next part of this thesis, chapters seven and eight, to compare economics, law and the accounting conceptual statements currently on issue to the framework. Chapter seven considers the discussion of

liabilities and equity by authors in the fields of law and economics. This is necessarily an overview, rather than a comprehensive analysis, but is of interest because accounting is part of the wider legal and economic environment (FASB SFAC1 1978). Chapter eight examines the current accounting conceptual statements issued by national/international accounting bodies, comparing them with the equity theories framework. It becomes clear from these two chapters that there are significant differences in the way law, economics and accounting view the distinction between liabilities and equity.

The final part of this thesis, chapters nine and ten, focuses upon the equity theory underlying the accounting conceptual statements' definitions of liabilities and equity, the non-compulsion equity theory. Chapter nine examines this theory, by questioning the consistency and validity of its reasoning and assumptions. Chapter ten concludes this thesis, by rejecting the non-compulsion equity theory. A different approach to the distinction between liabilities and equity is suggested.

CHAPTER TWO
THE IMPORTANCE OF THE DISTINCTION BETWEEN LIABILITIES AND EQUITY

2.1 Introduction

The balance sheet, or statement of financial position, contains three financial elements: assets, liabilities and equity. This chapter discusses the importance of the distinction between liabilities and equity. Section 2.2 considers the importance of this distinction for financial analysis purposes. This section discusses risk and profitability ratios, such as the proprietary ratio, the debt-to-equity ratio, and return on equity. Section 2.3 discusses the importance of the distinction for contractual compliance purposes, where loan contracts contain restrictive covenants limiting the amount of debt that an entity may issue. Section 2.4 addresses the importance of the distinction for the company law compliance purposes in relation to the solvency test, which was recently introduced into New Zealand's company law. Section 2.5 summaries this chapter.

2.2 Financial Statement Analysis

Financial statement analysis involves the use of ratios to examine key relationships within the financial statements at a particular time, and trends in these relationships over time (Samuels et al. 1995). The purpose of financial analysis is to extract information from financial statements to assist in evaluating an entity's activities, profitability, efficiency and degree of risk. Financial analysis information is used by various groups who have an interest in the entity, including current and prospective shareholders, security analysts,

lenders, executive managers, directors, customers, suppliers, employees, government and other agencies, and other interest groups (Samuels et al. 1995; McMullen 1979).

Some financial ratios rely on the distinction between liabilities and equity, because liabilities and/or equity feature as the numerator and/or denominator in the ratio calculation. Examples include the proprietary ratio and the debt-to-equity ratio, which are used to evaluate risk, and return on equity, which is used to evaluate profitability. These risk and profitability ratios are discussed in turn.

Risk Ratios

Risk ratios are of particular interest to shareholders, both current and prospective, their advisors, and lenders (Lev 1974, Frishkoff 1981, Ford 1995). The ratios are viewed as a measure of financial strength and long-term liquidity.

Risk ratios include the following ratios:

- Proprietary Ratio: $\frac{\text{Total Equity}}{\text{Total Assets}}$
- Debt-to-Equity Ratio: $\frac{\text{Total Debt}}{\text{Total Equity}}$

Each of these two ratios examines the relationship between two of the three financial elements that appear in the statement of financial position: assets, liabilities and equity. As total assets equals the sum of total liabilities (debt) plus total equity, then the two ratios are different approaches to examining the financing structure of an entity. For example, as the amount of debt relative to the amount of equity increases, the proprietary ratio will fall while the debt-to-equity ratio will rise.

Generally, the higher the proportion of equity, the lower the perceived financial risk. A high proportion of equity suggests that there is little danger of liquidation or forced reorganisation arising from defaulted loan obligations (McMullen 1979; Paton and Dixon 1958; O'Brien 1997).

Because these ratios use debt and/or equity as their numerator and/or denominator, these ratios will be affected by the distinction between liabilities and equity (Foster 1978). For example, the reclassification of debt as equity will improve the investment attraction of an entity by increasing its proprietary ratio and reducing its debt-to-equity ratio, thus reducing the apparent risk associated with the provision of finance to that entity (Westwood 1995).

Profitability Ratios

One commonly used profitability ratio is return on equity (Shay 1995, Di Vittorio 1995). This ratio is calculated as net income divided by equity. For business entities, profitability ratios, such as return on equity, are of greatest interest to current and prospective shareholders and their advisors (Frishkoff 1981), who use these ratios to assess the likely returns on their investments. Accordingly, business entities may have an incentive to reclassify equity as debt, to increase their reported return on equity ratio.

Other entities may be more concerned with reducing their return on equity ratio, and thus have an incentive to reclassify debt as equity. For example, natural gas utilities in the United States of America are subject to state regulations that determine the maximum allowable return on equity. Some entities may be subject to political restrictions, in that it may not be politically acceptable for such entities to generate what may be seen as

excessive returns on equity. For example, New Zealand's Electricorp has been criticised for generating "super-profits" (Hardy 1993).

Therefore, the classification of sources of finance as liabilities or equity will impact upon the return on equity calculation. The reclassification of equity as debt will increase the return on equity ratio, and vice versa.

2.3 Compliance with Loan Contracts

Some loan agreements contain restrictive covenants that limit the amount of debt that an entity may issue. The purpose of these restrictive covenants is to limit the amount of risk borne by the lender. The more debt relative to equity that an entity has, the higher the risk to lenders that the borrowing entity may default on its loan obligations. Therefore, if the borrowing entity raises more debt, this will increase the risk to existing lenders. To prevent what the lender considers to be unacceptable increases in risk, restrictive covenants may be placed in the loan contract to limit the amount of debt the borrowing entity may issue.

The distinction between liabilities and equity therefore impacts upon compliance with such loan contracts. If the entity is able to issue debt but classify it as equity, this may give the appearance that the restrictive covenants contained in existing loan contracts have not been breached. However, the additional debt will increase the risk borne by existing lenders, thus prejudicing their interests (Westwood 1995, Whittred et al. 1996).

2.4 Company Law Compliance

New Zealand's 1993 company law reform included the introduction of a solvency test, which is intended to measure a company's ability to pay its creditors. The solvency test

must be satisfied before distributions to shareholders are made. The purpose of this test is to ensure that any transfer of a company's resources to its shareholders will not impair the company's ability to pay its creditors.

The solvency test has two limbs. The first limb, called the liquidity test, stipulates that the company must be able to pay its debts as they fall due in the normal course of business, after the distribution is made. The second limb, known as the balance sheet test, requires that the value of the company's assets must exceed the value of its liabilities, including contingent liabilities, after the distribution is made (Companies Act 1993).

To apply the balance sheet test, the directors must determine which claims come within the meaning of "liabilities". The term is not defined in the legislation, apart from stipulating that "liabilities" includes the amounts necessary to satisfy the claims (upon dissolution of the company) of shareholders with preferential rights (Companies Act 1993).

The directors have a statutory obligation to consider the company's most recent financial statements when applying the solvency test (Companies Act 1993). Therefore, the classification of sources of finance as liabilities or equity for financial reporting purposes will impact upon the application of the solvency test. For example, if debt is reclassified as equity, this will improve the company's apparent ability to meet the solvency test. This may allow distributions to shareholders to be made at a time when the company's solvency is questionable. The reduction in the company's assets resulting from the distribution to shareholders will prejudice the interests of creditors, as it reduces the assets available to meet creditors' claims (Ross, 1994).

2.5 Summary and Conclusion

This chapter demonstrated that the distinction between liabilities and equity is important for financial statement analysis purposes, contractual compliance and company law compliance. The classification of particular financial instruments as liabilities or equity impacts upon financial ratios, such as the proprietary ratio, the debt-to-equity ratio, and the return on equity ratio, which are used to measure risk and profitability. The reclassification of debt as equity, or vice versa, may therefore impact upon the decisions made by users of these ratios, such as current and prospective shareholders, and lenders.

The classification of financial instruments also affects loan agreements, which may contain restrictive covenants limiting the amount of debt a company may issue. If the borrowing entity is able to issue debt but classify it as equity, this avoids an apparent breach of the restrictive covenants contained in existing loan contracts. However, the additional debt will increase the risk borne by existing lenders, thus prejudicing their interests.

Finally, the classification of sources of finance as either liabilities or equity impacts upon the application of the balance sheet limb of the solvency test, recently introduced into New Zealand company law. Classifying debt as equity may prejudice the interests of creditors, because it may enable shareholder distributions at a time when the company's solvency is questionable, thus reducing the amount of assets available to meet creditors' claims.

In summary, the distinction between liabilities and equity is important for a number of reasons. However, the distinction has become blurred by hybrid financial instruments, which are discussed in the next chapter.

CHAPTER THREE
HYBRID INSTRUMENTS

3.1 Introduction

Chapter two discussed the importance of the distinction between liabilities and equity. This chapter discusses hybrid financial instruments in relation to this distinction. Section 3.2 considers the nature of hybrid instruments, including two examples, convertible debt and preference shares. Section 3.3 discusses how hybrid instruments have blurred the distinction between liabilities and equity. Section 3.4 considers how this blurring of the distinction may be used to the advantage of the issuing entity. Section 3.5 summarises this chapter.

3.2 The Nature of Hybrid Instruments

The term "hybrid instruments" refers to financial instruments that have characteristics of both debt and equity (FASB 1990, Lewis and Pendrill 1996). Equity, in the case of business entities, is considered to represent the ownership interest (FASB SFAC6 1985). Owners bear the most risk in terms of both returns on and of their investment, participate in profits and bear its losses, and have control over the entity's assets (Sprague 1907, Paton and Dixon 1958, Kerr 1989, Pope and Puxty 1991). Owners' interests rank below debt holders' interests as a claim to the entity's assets (FASB SFAC6, Kerr 1989). Debt holders' interests, therefore, rank above owners' interests, do not participate in the entity's profits or bear its losses, receive a fixed return on their investment, hence bear less risk than owners in terms of returns on and of their investment, and generally do not have control over the entity's assets. Hybrid instruments combine some of the features associated with owners' interests with some of the features associated with debt holders'

interests, so have characteristics of both debt and equity. Examples of hybrid instruments include convertible debt and preferred stock.

Convertible Debt

Convertible debt gives the lender the right to exchange the debt for other securities, usually shares, without the payment of any additional consideration. This allows the lender to participate in the good fortunes of the company if the company is successful, by becoming a shareholder. Conversely, if the company is not successful, the lender may instead remain as a lender, thus limiting the lender's risk to the amount of the original debt. In recognition of this valuable option, convertible debt usually has a lower interest rate than non-convertible debt of the same risk and maturity (Whittred et al. 1996).

Preference Shares

Preference shares usually give holders a preference in two ways: firstly, assuming the company has made sufficient profits, stipulated dividends are required to be paid to the preference shareholders before any dividend is paid to ordinary shareholders; secondly, in the event of the company being wound up, the capital contributed by preference shareholders is repaid prior to any amounts being paid to ordinary shareholders (Whittred et al. 1996).

Other rights attaching to preference shares depend on the terms of issue. The shares may have a right to participate in profits and/or surplus assets upon winding up, beyond the fixed amount of the preferred dividend/capital. They may be cumulative or non-cumulative, meaning that any preferred dividends not paid in previous years may or may not have to be made up before any dividends are paid to ordinary shareholders. Preference

shares may or may not have voting rights. They may be convertible into ordinary shares. Preference shares may also be redeemable, either mandatorily, or at the option of the holder (a put option) and/or at the option of the issuer (a call option). Finally, the payment of the preference dividend and the put option may be guaranteed by a third party, such as a parent company or a bank (Whittred et al. 1996).

Legally, preference shares are considered to be shareholders' equity (Westwood 1995, Whittred et al. 1996). However, depending on the rights attaching to a particular issue of preference shares, these shares may be more like debt than equity. An example of debt-like preference shares are those that are non-voting, non-participating, redeemable either mandatorily or at the option of the holder, and secured by a guarantee from a third party.

3.3 The Blurring of the Distinction Between Liabilities and Equity

Because hybrid instruments have characteristics of both debt and equity, they are difficult to classify as either debt or equity (Whittred et al. 1996). Thus, hybrid instruments have blurred the distinction between liabilities and equity.

This classification problem is not new, as certain types of hybrid instruments have existed for decades, such as convertible debt and preferred stock (FASB 1990, McInnes et al. 1990). However, recent innovations in the financial markets have increased the use and variety of hybrid instruments (FASB 1990, McInnes et al. 1990, Lewis and Pendrill 1996). Consequently, classifying hybrid instruments as either debt or equity is now a greater problem than in the past (FASB 1990, Lennard 1992, Samuels et al. 1995).

3.4 Incentives to Use Hybrid Instruments

The classification of hybrid instruments is uncertain. Entities may take advantage of this uncertainty by using a hybrid instrument to, say, issue debt but classify it as equity. This may enhance the investment attraction of the entity by reducing its debt-to-equity ratio, and/or enabling it to circumvent restrictive covenants in existing loan contracts (Westwood 1995, Whittred et al. 1996).

The following quote from a technical brief on auction market preferred stock illustrates the advantages to the issuing entity of the debt/equity classification uncertainty associated with hybrid instruments:

> The dream of every finance executive is a hybrid instrument, which is classified as equity when calculating gearing ratios, but does not dilute ordinary shares and share price, is as cheap as debt, and whose return ranks as interest for tax purposes (Anonymous, World Accounting Report, May 1991, p 11).

3.5 Summary

Hybrid financial instruments, such as preference shares and convertible debt, have characteristics of both debt and equity, making them difficult to classify. They have blurred the distinction between liabilities and equity. While hybrid instruments have existed for decades, the recent increase in the use and variety of hybrid instruments has considerably enlarged the problem of classifying them. This in turn has increased opportunities to manipulate accounting information, where incentives exist to classify finance as equity rather than debt, or vice versa.

CHAPTER FOUR
RESEARCH FOCUS, QUESTION AND METHOD

4.1 Research Focus

This research focuses upon the conceptual distinction between liabilities and equity, rather than the distinction made in accounting practice. The conceptual statements issued by various national and international accounting bodies are intended to provide guidance to standard setters when formulating or revising accounting standards, and to accounting practitioners when preparing, reviewing or auditing financial statements (IASC 1989). It appears, therefore, that these conceptual statements will shape future accounting practice. Also, as noted in chapter one, there appears to be unanswered questions concerning the conceptual distinction between liabilities and equity, including whether the line between liabilities and equity should be moved or eliminated. Furthermore, if the conceptual statements' definitions are to be applied to accounting practice, it is important that they are clearly understood. For these reasons, this research focuses upon the conceptual distinction between liabilities and equity, rather than the distinction currently made in practice.

The conceptual statements issued by various national and international accounting bodies are intended to be universally applicable, that is, appropriate for all types of entities, both public sector and private sector entities, and both for-profit and not-for-profit entities. This research focuses upon the private for-profit sector. One reason for doing so is to limit the scope of this research to a manageable size. Also, some of the issues raised in chapter two concerning the importance of the distinction between liabilities and equity, such as for

financial analysis purposes and company law compliance, have a greater relevance to the private for-profit sector.

4.2 Research Question and Method

The primary research question is determining the conceptual distinction between liabilities and equity. There are a number of related secondary questions that this research will address, in the context of addressing the primary research question, such as:

What are liabilities? What is equity? Why is the distinction between them important? Should the conceptual statements' definitions of liabilities and equity be changed? If so, which basis for distinguishing between liabilities and equity should be used to formulate new definitions?

Because this research is focused upon the conceptual distinction between liabilities and equity, rather than the distinction made in accounting practice, this research is conducted by way of a literature review.

A preliminary review of accounting literature revealed that there are various equity theories that distinguish between liabilities and equity differently. For example, Hendriksen (1977) began his discussion on the nature of ownership equities by outlining a variety of equity theories. This indicates that an understanding of these equity theories is required before the distinction between liabilities and equity may be considered further.

Accordingly, several equity theories are reviewed and summarised into an equity theories framework, which outlines these theories' main features, including their position on the meaning of "liabilities" and "equity".

Because the current accounting conceptual statements issued by national/international accounting bodies were derived from accounting literature (Stephenson and Chapman 1992), a selection of prominent accounting authors are reviewed. The equity theories framework developed earlier is used to determine which underlying equity theory these authors adopted. As part of this process, the equity theories framework is revised, to incorporate another equity theory that appears to have considerable support in the accounting literature.

Because accounting does not exist for its own sake, but is part of the wider legal and economic environment (FASB SFAC1 1978), some material from the related fields of law and economics is then reviewed, to determine if, and how, law and economics differentiates between liabilities and equity. This entails comparing the discussion of liabilities and equity in this literature to the equity theories framework.

The above process provides the background for examining the current accounting conceptual statements issued by national/international accounting bodies, including their definitions of liabilities and equity. The equity theories framework is used to establish, firstly, whether these conceptual statements are consistent in their application of the underlying equity theory, and, secondly, which equity theory is followed by the conceptual statements' definitions of liabilities and equity.

Having found that these conceptual statements' definitions are based upon an equity theory that appears to have little, if any, support from the law and economics literature, this particular equity theory is more closely examined. This entails examining certain basic features of the theory, to determine whether these features are based upon consistent reasoning and supportable assumptions, by comparing parts of the conceptual statements' discussion with other parts, and with accounting, finance, law and economics literature.

CHAPTER FIVE
EQUITY THEORIES

5.1 Introduction

This chapter considers several equity theories. These theories view equity, and its distinction from liabilities, from different perspectives. Before the distinction between liabilities and equity is examined in greater detail, it is appropriate to consider the perspective from which such a distinction is drawn.

There are two main equity theories discussed in accounting literature: the proprietary theory and the entity theory (Gynther 1967). These two theories are outlined in sections 5.2 and 5.3 respectively, and section 5.4 discusses the differences between them. Section 5.5 considers the residual equity theory, which falls somewhere between the proprietary and entity theories (Hendriksen 1977). Section 5.6 summarises the differences between the proprietary, entity and residual equity theories. Section 5.7 then briefly considers two other equity theories, the enterprise theory and the fund theory, which are extensions of the entity theory. Section 5.8 concludes this chapter, noting that the conceptual distinction between liabilities and equity is dependent upon the underlying equity theory adopted.

5.2 Proprietary Theory

The proprietary theory places the proprietor in the central position of the accounting equation. Assets represent resources owned by the proprietor; liabilities are debts or obligations of the proprietor; and revenues and expenses represent changes in proprietorship (Vatter 1947, Gynther 1967, Hendriksen 1977).

The proprietary theory is also viewed as a wealth concept: proprietorship is the net value of the business to its proprietors. Net income accrues directly to the proprietors and thus represents an increase in their wealth (Vatter 1947, Gynther 1967, Hendriksen 1977).

The accounting equation under the proprietary theory is therefore:

Assets - Liabilities = Proprietorship.

Under the proprietary theory, liabilities and proprietors' equity are fundamentally different in concept. The following comments of Sprague (1907), made while rejecting the notion that the proprietors' interest should be treated as part of an entity's liabilities, illustrates the proprietary theory's view of equity:

> Surely The Business does not stand in the same relation to its proprietors or its capitalists as to its "other" liabilities. It would seem more appropriate to say that it is "owned by" than "owes" the proprietors (57)

The proprietary theory views the entity's liabilities as being obligations, while the proprietors' equity is not in any sense an obligation (Bird et al. 1974). An obligation requires the entity to transfer resources, such as money, goods or services, from the entity to another party *outside the entity* at some time in the future (Hendriksen 1977). Because the entity is not viewed as existing separately from the proprietors, the proprietors are not "outside" the entity. For an obligation to exist, it must require the entity to transfer resources to a party other than the proprietors. Hence, proprietors' equity is not an obligation of the entity.

5.3 Entity Theory

The entity theory stresses the importance of the entity as an organisation separate from the proprietors. This separate existence is supported by legislation, in the case of the corporation (Hendriksen 1977). Because of this, an explanation of the entity theory is likely to be clearer if approached from the perspective of the corporation. Therefore, the following discussion of the entity theory uses terminology applicable to the corporation, such as "stockholders" rather than "proprietors". This discussion should not, however, be taken to imply that the entity theory is applicable only to corporations.

Under the entity theory, the fundamental accounting equation is:

Assets = Liabilities (Gilman 1939, Bird et al. 1974)

or

Assets = Equities (Paton 1922, Hendriksen 1977).

Assets represent rights accruing to the entity, while creditors and stockholders have equities in the entity (Gynther 1967, Hendriksen 1977). Under the entity theory, there is no conceptual distinction between the various parties who have a financial interest in the entity; they are all "equity holders" (Hendriksen 1977). That is, the interests of both creditors and stockholders form part of the total "equities" (Paton 1922, Hendriksen 1977) or "liabilities" (Gilman 1939, Bird et al. 1974), irrespective of any differences in the rights and conditions attached to the various financial interests (Paton 1922, Clark 1993). Stockholders' equity is thus considered to be the obligation or liability of the entity to its stockholders, in the same manner as the claims of creditors represent obligations or liabilities (Bird et al. 1974, Gilman 1939).

Some entity theorists prefer to distinguish between the claims of creditors and stockholders (Bird et al. 1974). The basis for such a distinction is that the claims of creditors are fixed and contractual, as the amounts due to creditors can be independently measured if the firm is solvent. In contrast, the stockholders' claim is elastic and residual, as its measurement is dependent upon the valuation of assets and liabilities (Paton 1922, Bird et al. 1974, Hendriksen 1977). However, the rights of stockholders to receive dividends and the net assets upon liquidation are viewed as being based upon their rights as "equity holders", rather than as owners of the entity's assets (Hendriksen 1977). Therefore, any distinction between the claims of creditors and stockholders under the entity theory is merely a sub-classification of the various financial interests, rather than an indication of any fundamental conceptual difference between them (Paton 1922).

5.4 Proprietary Theory and Entity Theory Contrasted

The proprietary and entity theories differ in several ways. These differences include the nature of the relationship between the entity and the proprietors, the focus of financial reporting, the nature of equity, the nature of transfers between the entity and proprietors, and the accounting treatment of interest and dividends. These differences are examined below.

Relationship Between the Entity and the Proprietors

The proprietary theory considers that the entity does not exist separately from its proprietors. Therefore, the entity's assets are viewed as belonging to the proprietors and the entity's liabilities are viewed as owing by the proprietors. In contrast, the entity theory considers that the entity has its own existence, separate from the proprietors. Hence, the

entity's assets are viewed as belonging to the entity, not the proprietors, and the entity's liabilities are viewed as being liabilities of the entity itself, not of the proprietors.

Financial Reporting Focus

The focus of financial reporting under the proprietary theory is the proprietors, with the entity viewed as an agent of the proprietors. In contrast, the entity theory focuses upon the entity itself, separate from the proprietors (Gynther 1967, Bird et al. 1974). Therefore, under the entity theory, the proprietors are merely one group of persons having an interest in the entity, and are of no greater importance than any other interested parties, such as creditors (Clark 1993).

Nature of Equity

The entity theory considers that the entity has its own existence, separate from the proprietors, therefore all financial interests in the entity are obligations of the entity. Thus, proprietors' equity is an obligation of the entity, in the same manner as creditors' claims are obligations.

In contrast, the proprietary theory considers that the entity does not exist separately from its proprietors, so the entity's obligations are limited to the financial interests of parties other than the proprietors. Hence, proprietors' equity is not considered to be in any sense an obligation of the entity (Bird et al. 1974).

Thus, under the entity theory, "liabilities" and "equity" are conceptually the same, while, under the proprietary theory, "liabilities" and "equity" are conceptually very different.

Nature of Transfers between the Entity and Proprietors

Transfers between the entity and other parties are considered to be reciprocal where the transfers involve "obtaining resources or satisfying obligations by giving up other resources or incurring other obligations" (AICPA 1970). Under the entity theory, because both liabilities and stockholders' equity are obligations, all transactions with financial interest holders, whether they are with stockholders or creditors, are *reciprocal* in nature. The transfer of resources from/to the stockholders results in an increase/decrease of the entity's obligations to its stockholders.

Under the proprietary theory, proprietors' equity is not considered to be an obligation of the entity (Bird et al. 1974). Contributions by proprietors result in the entity obtaining resources without giving anything in exchange - the entity neither incurs an obligation nor gives any resources to the proprietors in exchange for their contributions. Similarly, distributions to proprietors result in the entity giving up resources without receiving anything in exchange - the entity neither obtains any resources, nor satisfies any obligations, in exchange for the distribution to the proprietors. For this reason, transfers between the entity and its owners are viewed as *non-reciprocal* under the proprietary theory.

For example, consider an issue of ordinary shares for cash. Under the entity theory, the shares issued in return for the cash are considered to create a claim against the entity, that is, an obligation. Hence, the transfer is reciprocal under the entity theory: an asset is received and an obligation incurred. In contrast, under the proprietary theory, the shares issued in exchange for the cash do not give rise to a claim against the entity; the shares merely record the proprietary contribution. The transfer is therefore non-reciprocal under

the proprietary theory: an asset is received, but no asset is given up nor is an obligation incurred.

Treatment of Interest and Dividends

Under the entity theory, there is no conceptual distinction made between the various parties who have a financial interest in the entity, such as creditors and stockholders. Any returns payable on these financial interests, such as interest and dividends, are of the same nature. Adherence to the entity theory requires interest on debt to be treated in the same manner as dividends to stockholders, either as distributions of income (Hendriksen 1977) or as expenses (Gynther 1967). Conversely, under the proprietary theory, interest on debt is considered to be an expense, while dividends to stockholders represent a withdrawal of stockholders' equity (Hendriksen 1977).

5.5 Residual Equity Theory

The proprietary and entity theories are the two main equity theories discussed in the accounting literature (Gynther 1967). Other theories tend to be variations of these theories. One such variation is the residual equity theory, which falls somewhere between the proprietary theory and the entity theory (Hendriksen 1977). The accounting equation under the residual equity theory is:

Assets – Specific Equities = Residual Equity (Hendriksen 1977)

or

Assets – Liabilities = Residual Equity (Staubus 1959)

"Specific Equities" (Hendriksen 1977) or "Liabilities" (Staubus 1959) under the residual equity theory are fixed interests, being interests that require definite fixed amounts of cash disbursements in the future, and include creditors and non-participating preferred stockholders. "Residual Equity" is the residual interest, which requires indefinite variable amounts of cash disbursements in the future. In the case of a corporation, the residual equity holders are usually the common stockholders – the exception being where the entity does not have sufficient assets to repay the specific equities, in which case the lowest ranking specific equity holders become the residual equity holders (Staubus 1959, Hendriksen 1977).

Residual Equity Theory and Proprietary Theory Compared and Contrasted

While the accounting equation for the residual equity theory appears similar to the proprietary theory, the claims of the proprietors/residual equity holders to the entity's assets is viewed differently under each theory. Under the residual equity theory, the residual equity holders have only the *residual claim* to the entity's assets, that is, they are the claimants to the *residue* of the assets that remain after deducting the claims to the assets of the specific equity holders (Staubus 1959). In contrast, under the proprietary theory, the proprietors are viewed as owning *all* of the entity's assets, not just the amount represented by equity.

Also, under the residual equity theory, all financial interests are viewed as obligations of the entity. These obligations are divided into "liabilities" and "equity", where "liabilities" are the fixed prior interests, and "equity" is the variable residual interest. Therefore, proprietors' interests will be included in "liabilities" where those interests are for fixed amounts. In contrast, under the proprietary theory, "liabilities" are the entity's obligations,

while "equity" is not in any sense an obligation of the entity (Bird et al. 1974). This automatically excludes the proprietors' interests from "liabilities".

Because both theories derive "equity" from the difference between assets and liabilities, the meaning of "liabilities" impacts upon how "equity" is determined. This means that the classification of financial interests as "liabilities" or "equity" will be different in some cases under the two theories. For example, under the proprietary theory, preferred stockholders are commonly thought of as being proprietors (Staubus 1959). In contrast, under the residual equity theory, preferred stockholders will not qualify as residual equity holders if their interest is fixed rather than residual - except where there are insufficient assets to repay the amounts due to preferred stockholders, in which case they would then become the residual equity holders (Staubus 1959, Hendriksen 1977).

Under the residual equity theory, it is possible that creditors may become the residual equity holders, where there are insufficient assets to repay all specific equity holders (Staubus 1959). The reclassification of creditors in this manner would not occur under the proprietary theory, because "liabilities" are obligations, while "equity" is not an obligation of the entity (Bird et al. 1974). Therefore, as long as the entity has an obligation to pay its creditors, irrespective of whether it is able to do so, creditors are classified as "liabilities" under the proprietary theory.

Another way in which the residual equity theory and the proprietary theory may be contrasted is in their applicability to various types of entities. Every entity has a residual equity, whereas not all entities have proprietors. Non-profit entities always have a group or groups of persons who, while not proprietors of the entity, would receive the residual assets in the event of the entity being wound up (Staubus 1959).

Residual Equity Theory and Entity Theory Compared and Contrasted

The residual equity theory is similar to the entity theory in that it views all those parties having a financial interest in the entity as "equity holders". This means that under the residual equity theory all financial interests, whether they are fixed or residual, are obligations, which is also the view of the entity theory. Hence, both the entity theory and the residual equity theory differ from the proprietary theory in their view of financial interests, as the proprietary theory does not consider that the proprietors' equity is an obligation (Bird et al. 1974).

Following on from this view of financial interests, under both the residual equity theory and the entity theory, transfers to/from owners are reciprocal in nature. Such transfers decrease/increase the entity's total obligations.

The residual equity theory appears similar to the entity theory. However, in contrast to the entity theory, the residual equity theory emphasises the distinction between the fixed and residual interests, as can be seen in the above accounting equation. In this way the residual equity theory focuses on the residual equity holders, rather than treating them as just another class of equity holders, as is the case with the entity theory (Hendriksen 1977).

Net Income under the Residual Equity Theory, Compared to the Proprietary and Entity Theories

The focus of financial reporting under the residual equity theory is on the interests of residual equity holders, rather then the interests of proprietors (as under the proprietary theory) or the entity (as under the entity theory). This affects how net income is determined.

Under the residual equity theory, all returns payable on the investments of fixed interests holders are expenses to be included in the determination of net income. In contrast, returns payable on the investments of residual equity holders are distributions of net income (Hendriksen 1977). This is similar in principle to the proprietary theory. However, because the residual equity theory defines "liabilities" differently from the proprietary theory, and therefore derives "equity" differently, the determination of net income is also different under the two theories. For example, interest on preferred stock may be an expense under the residual equity theory and a distribution of income under the proprietary theory, because the preferred stock may be classified as a liability under the residual equity theory and equity under the proprietary theory.

In contrast, the entity theory does not differentiate between types of returns on investments, because it does not differentiate between the investments themselves. The entity theory treats all interest and dividends in the same manner, either as expenses (Gynther 1967) or distributions of income (Hendriksen 1977).

5.6 Summary of the Proprietary, Entity and Residual Equity Theories

A summary of the differences and similarities between the three theories is set out in table one:

TABLE ONE
COMPARISON OF EQUITY THEORIES

	Proprietary Theory	**Entity Theory**	**Residual Equity Theory**
Entity and proprietors relationship	Entity does not exist separately from the proprietors	Entity exists in its own right, separate from the proprietors	Entity exists in its own right, separate from the proprietors
Financial reporting focus	Proprietors	Entity	Residual Equity Holders
What are "liabilities"?	Obligations to transfer resources from the entity to other parties outside of the entity, which necessarily excludes proprietors (the entity does not exist separately from the proprietors, hence proprietors are not "outside" the entity)	No conceptual distinction from "equity" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).	Fixed prior interests – obligations of the entity that require it to transfer definite sums to other parties outside the entity, including proprietors if their interest is fixed (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
What is "equity"?	Proprietors' net interest, that is, the proprietors' gross interest in all the assets less "liabilities", as determined above.	No conceptual distinction from "liabilities" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).	Variable residual interest, that is, the lowest-ranking obligation that is indefinite in amount, as it represents the claim to the residue of the assets that remain after deduction of "liabilities", as determined above.
Is "equity" an obligation of the entity?	No	Yes	Yes
Transfers to/from proprietors	Non-Reciprocal	Reciprocal	Reciprocal
Treatment of returns payable on investments by various parties having a financial interest in the entity	Expense if in respect of "liabilities", distribution of income if in respect of "equity"	All expenses or all distributions of income – no distinction between returns on investments of various parties	Expense if in respect of "liabilities", distribution of income if in respect of "equity"

The residual equity theory *appears* similar to the proprietary theory in that both theories derive equity from the difference between assets and liabilities. However, it is shown above that the two theories have fundamentally different approaches to the nature of, and the distinction between, liabilities and equity. Under the proprietary theory, liabilities represent obligations to parties other than the proprietors, and proprietors' equity is not considered to be an obligation of the entity. In contrast, under the residual equity theory, *all* financial interests, including those of the proprietors, are obligations. Instead, the residual equity theory differentiates between liabilities and equity on the basis of the quantifiability and ranking of the financial interest, as liabilities are fixed prior interests and equity is the variable residual interest.

Similarly, both the proprietary and residual equity theories *appear* to have the same approach to income determination: returns payable on investments are treated as an expense if in respect of "liabilities", and as a distribution of income if in respect of "equity". However, as the determination of "liabilities" differs under the two theories, the determination of net income also differs.

The residual equity theory accords with the entity theory, and differs from the proprietary theory, in its position that the entity exists separately from the proprietors/stockholders, that equity is an obligation of the entity, and that transfers between proprietors/stockholders are reciprocal in nature. It can be seen that the residual equity theory is closer to the entity theory than the proprietary theory.

5.7 Other Equity Theories

While the entity and proprietary theories represent the two main equity theories, with the residual equity theory falling between the two, there are other equity theories. These include the enterprise theory and the fund theory, which are discussed in this section. These theories are essentially extensions of the entity theory, so they make no conceptual distinction between liabilities and equity.

Enterprise Theory

Under the enterprise theory, the firm is considered a social institution operated for the benefit of many interested groups, including not only the firm's finance providers, such as stockholders, but also employees, customers, the government and the general public (Suojanen 1954, Ladd 1963, Gynther 1967, Hendriksen 1977).

Under this concept, income is a value-added concept: the market value of the goods and services produced by the firm less the value of goods and services acquired from other firms. Hence all dividends, interest, wages and salaries to employees, and taxes paid to the government, are allocations of enterprise income, not expenses to be deducted in its computation (Suojanen 1954, Hendriksen 1977).

The enterprise theory has been described as a broader concept than the entity theory (Suojanen 1954, Hendriksen 1977), and as an adjunct to the entity theory (Gynther 1967).

Fund Theory

The fund theory has also been described as an extension of the entity theory (Vatter 1955). Under this approach, the emphasis is on the operational or activity-oriented unit as the basis of accounting (Hendriksen 1977). The fund consists of a group of assets that have been brought together for some functional purpose (Vatter 1947). The fund theory is based upon the equation:

Assets = Restrictions on Assets (or Equities).

Assets represent "service potentials", that is, prospective services to the fund. The restrictions on assets may be imposed by legal, contractual, managerial, financial, or equitable considerations. Vatter (1947), a well-known proponent of the fund theory, described the fund theory concept of assets and "restrictions on assets" - which he also referred to as "equities" - as follows:

> The basic notion in all accounting terminology is the concept of service potentials, and the asset notion is the simplest expression of this...The equity notion, however, is not to be taken as accounting for assets in terms of their ownership, nor is it a matter of stating claims to assets; rather, equities are viewed as restrictions upon the assets in a fund (p. 21).

Vatter (1947) also discussed the notion of "residual equity" under the fund theory, and described this as "a final and pervasive restriction upon fund assets or a residual thereof" (20). This does not imply that there is any conceptual distinction between the "residual equity" and other "equities", as all interests are viewed as being restrictions on assets under the fund theory.

5.8 Conclusion

This chapter reviewed the equity theories receiving the most discussion in the accounting literature. The two main theories discussed are the proprietary theory and the entity theory. Other theories, which are essentially variations of these two main theories, have also received attention in the accounting literature, particularly the residual equity theory, which falls between the two main theories, although is closer to the entity theory than the proprietary theory.

This chapter demonstrated that the various equity theories have different approaches to the focus of financial reporting, the nature of the relationship between the entity and the proprietors, and the nature of equity and liabilities. The equity theory adopted in financial reporting impacts upon the way in which particular transactions are viewed, the determination of net income, and the classification of various financial interests. The various equity theories distinguish between liabilities and equity differently. The distinction between liabilities and equity therefore depends upon by the underlying equity theory adopted.

The equity theories reviewed in this chapter provide a framework for examining various views of equity and liabilities, such as those found in accounting literature, law and economics literature, and the accounting conceptual statements currently on issue, which are examined in the following chapters.

CHAPTER SIX
ACCOUNTING LITERATURE

6.1 Introduction

Various national accounting bodies, and the International Accounting Standards Committee (IASC), have issued conceptual statements for financial reporting. The definition of financial elements contained in these various conceptual statements, such as liabilities and equity, have been derived from accounting literature published over many decades (Stephenson and Chapman 1992). Before examining the conceptual statements themselves, it is appropriate to first review the discussion of liabilities and equity by various authors in accounting theory.

Authors were selected for this chapter primarily because of their prominence in accounting literature, so as to include those authors whose views are likely to have been drawn upon when the various conceptual frameworks were being developed. For instance, Kerr (1989) prepared her research monograph on the concept of equity as part of a project then being undertaken by the Australian Accounting Research Foundation to develop a conceptual framework. She included a literature survey that included a number of the authors discussed in this chapter. Also, the selection process entailed considering whether particular authors discussed liabilities and equity in sufficient depth to enable meaningful conclusions to be drawn. Certain prominent authors, whose work lacked this in-depth discussion, such as Paton and Littleton (1940), were therefore excluded from this review.

The preceding chapter demonstrated that distinguishing between equity and liabilities requires consideration of the underlying equity theory. This chapter therefore seeks to identify the equity theory adopted by each author, by comparing their discussion of equity and liabilities to the equity theories previously reviewed. Those authors with views

corresponding to either the proprietary theory, the entity theory, or the residual equity theory are discussed in sections 6.2 to 6.4 respectively. The prominence of the proprietary and entity theories in the accounting literature, along with the residual equity theory variation, implies that most authors are likely to follow one of these three theories, or possibly following some other known equity theory, such as the fund theory or the enterprise theory. Surprisingly, a considerable number of authors appear to follow another equity theory, that has not been specifically identified as an equity theory in the accounting literature. This other theory is similar to the proprietary theory in many respects, which may explain why its existence has not been noted before. However, it also has features in common with the entity and residual equity theories, so is clearly different from the proprietary theory. Section 6.5 presents this other equity theory. Section 6.6 summarises this chapter.

6.2 Proprietary Theory

Of the nine authors selected for review for this chapter, only one, namely Sprague (1907), could be clearly identified with the proprietary theory. There were others who initially appeared to support the proprietary theory, but upon closer examination, instead seem to support the other equity theory discussed in section 6.5.

Chapter five identified the main features of the proprietary theory, which are set out in table two:

TABLE TWO
PROPRIETARY THEORY

Entity/proprietors' relationship	Entity does not exist separately from the proprietors
Financial reporting focus	Proprietors
What are "liabilities"	Obligations to transfer resources from the entity to other parties outside of the entity, which necessarily excludes proprietors (the entity does not exist separately from the proprietors, hence proprietors are not "outside" the entity)
What is "equity"	Proprietors' net interest, that is, the proprietors' gross interest in all the assets less "liabilities", as determined above.
Is "equity" an obligation of the entity?	No
Treatment of transfers to/from proprietors	Non-reciprocal
Treatment of returns payable on investments by various parties having a financial interest in the entity	Expense if in respect of "liabilities", distribution of income if in respect of "equity"

6.2.1 Sprague (1907)

Sprague appeared to support the proprietary theory, as indicated by his frequent references to the proprietor. The following comment demonstrates Sprague's focus upon the proprietor:

> The assets being regarded as composed of rights against others and the liabilities as others' rights against us, the excess of rights in our favour is the proprietorship (52)

Sprague considered that proprietors' rights differ materially from the rights of creditors:

> 1. The rights of the proprietor involve dominion over the assets and power to use them as he pleases even to alienating them, while the creditor cannot interfere with him or them except in extraordinary circumstances.

> 2. The right of the creditor is limited to a definite sum which does not shrink when the assets shrink, while that of the proprietor is of an elastic value.
> 3. Losses, expenses and shrinkage fall upon the proprietor alone, and profits, revenue, and increase of value benefit him alone, not his creditors (53).

The first of these differences is consistent with the proprietary theory view of assets as being owned by the proprietors. Ownership entitles a person to use the assets personally, rent or give the use of the assets to someone else, use the assets to secure a loan, sell the assets, or abandon them (Davidson et al. 1984).

The second and third differences taken together imply that creditors' claims are for fixed amounts, while proprietors' equity is variable, because proprietors, not creditors, bear the risks and rewards of the entity's operations. Such an approach to equity seems more consistent with the residual equity theory, where liabilities are fixed prior interests and equity is the variable residual. In contrast, under the proprietary theory, although revenues and expenses represent changes in the *total* of proprietors' equity (Gynther 1967, Hendriksen 1977, Vatter 1947), some non-participating interests are included *within* equity. For example, preference shareholders are usually viewed as being proprietors under the proprietary theory (Staubus 1959). Sprague defined "proprietors" more narrowly, as being only those who bear the entity's losses and benefit from its profits. In this respect, Sprague's approach to proprietors may be more consistent with the residual equity theory than the proprietary theory.

One difference between liabilities and proprietorship not listed in Sprague's differentiation, but fundamental to the proprietary theory, is that liabilities are viewed as obligations while proprietorship is not. However, Sprague did later consider whether the claims of the proprietors were a liability of the business entity, and rejected this notion:

> It would seem more appropriate to say that it (the business entity) is "owned by" than "owes" the proprietors (57).

Clearly, proprietors' equity is not an obligation, in Sprague's view. Also, his view of the entity as being "owned by" the proprietors is consistent with the proprietary theory, which does not view the entity as existing separately from its proprietors. Therefore, the entity's assets are considered to be owned by the proprietors.

Sprague also discussed the determination of net profit in a manner consistent with the proprietary theory. For instance, he presented a "Profit and Loss" statement that included interest on debt as a deduction in the determination of net profit and dividends to proprietors as an allocation of net profit (83).

6.2.2 Summary

Sprague is one of the few authors examined who can be clearly linked to the proprietary theory. For example, his discussion focused upon the interests of the proprietors, he treated interest on debt as a deduction in determining net profit and dividends as an allocation of net profit, he did not consider proprietors' equity to be an obligation of the entity, and he viewed the entity as being owned by the proprietors, consistent with the proprietary theory. Some of Sprague's views may indicate that the residual equity theory has also been applied, as proprietors' equity is stated to be elastic rather than fixed in amount, increasing and decreasing by the results of operations, consistent with the residual equity theory. However, this could be viewed as a narrower approach to the proprietary theory, with proprietors being only those who bear the risks and rewards of the entity's operations. Overall, Sprague's discussion is clearly consistent with the proprietary theory.

6.3 Entity Theory

Two of the authors selected for review for this chapter appear to support the entity theory, namely, Paton (1922) and Anthony (1983), although there are some differences in their views.

Table three represents a summary of the main features of the entity theory, as established in chapter five.

TABLE THREE
ENTITY THEORY

Entity/proprietors' relationship	Entity exists in its own right, separate from the proprietors
Financial reporting focus	Entity
What are "liabilities"	No conceptual distinction from "equity" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
What is "equity"	No conceptual distinction from "liabilities" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
Is "equity" an obligation of the entity?	Yes
Treatment of transfers to/from proprietors	Reciprocal
Treatment of returns payable on investments by various parties having a financial interest in the entity	All expenses or all distributions of income - no distinction between returns on investments of various parties

6.3.1 Paton (1922)

Paton rejected the proprietary theory view that the balance sheet consisted of three distinct classes: assets, liabilities and proprietorship. Instead he viewed proprietorship and liabilities as parts of a larger class: equities (51-53). Consequently, he concluded that the balance sheet consisted of two distinct classes: assets (which he termed properties) and equities.

Paton reviewed the proprietary theory approach to liabilities and proprietorship, which views the proprietor as owning the assets and owing the liabilities (57). He considered the aspects of risk and control associated with liabilities and proprietorship, from both the legal and economic perspective. Paton concluded that there was no fundamental distinction between liabilities and proprietorship, only differences in the degree of risk and control:

> ...it cannot be stated too emphatically that every equity, proprietary or otherwise, furnishes capital (money, commodities, or services); every equity involves risk of loss; virtually all equities have some privileges and responsibilities with respect to management; and all long-term equities have rights in income and capital (60-61).

Paton acknowledged that the proprietary theory approach to liabilities and proprietorship was satisfactory in the case of sole proprietorship and partnerships (65). However, in the case of the corporation, Paton considered that the proprietary theory was not appropriate. He reviewed various types of shares and bonds in existence at the time and concluded that, based upon the degree of risk and/or control attached to these securities, there was no clear dividing line that corresponded to the proprietor-creditor grouping of the sole-proprietorship (69-73).

Paton's approach to the accounting equation, and his discussion of the corporation, is consistent with the entity theory. For instance, he commented that, in the case of a corporation:

> The stockholder is not the owner; he has merely an equity. The same can be said of the other investors. The managerial view, a conception of the corporation as a legal and economic entity operating a mass of properties in the interest of a whole body of investors of various classes, is the proper starting point (84).

Paton did, however, note that the stockholders' equity was important. He introduced the notion of "residual equity", commenting that the liabilities are usually fixed and contractual, while stockholders' equity is "elastic and residual" (84-85). Paton commented that the residual equity did not consist of all stockholders' interests. In the case of a corporation, it was represented by the common stockholders' interest. Paton noted that the interests of preferred stockholders should be classified with the interests of bondholders and other contractual security-holders, because preferred stockholders interests were generally fixed, with little direct control (85).

Paton's discussion of stockholders' equity as a residual is consistent with the residual equity theory. However, he did not support the view that residual equity was a "pivotal and entirely independent category", as this would lead to "improper analysis" (87). Preparing the income statement from the perspective of the common stockholders would mean all interest and dividends accruing to all prior equities would be treated as deductions in determining the residual return. Paton did not support this approach to income determination:

> Net operating revenue measures the net increase (allowance being made for withdrawals and new investments) in *all the equities*. A rational cleavage is thus developed between *deductions* from *gross* revenue, and *distributions* of *net* revenue (88, emphasis in original).

Consistent with the entity theory, and inconsistent with the residual equity theory, Paton considered that all interest and dividends should be similarly treated, as distributions of net income.

Paton adopted the entity theory approach to liabilities and equity; that is, there is no fundamental distinction between them. He favoured the presentation of equities in two categories, fixed interests and residual equity. While this presentation implies the adoption of the residual equity theory, Paton clearly supported the entity theory approach to income determination, where interest and dividends to *all* equity holders are viewed as distributions of net income, rather than as deductions included in the determination of net income.

6.3.2 Anthony (1983)

Anthony developed his own conceptual framework for financial reporting as he considered that the Financial Accounting Standards Board (FASB) conceptual framework did not provide the guidance needed to develop a sound body of standards (10). He considered that the FASB concepts statements were too vague, such that "practically any proposed standard can be said to be consistent with them" (10).

Anthony favoured the entity approach to financial reporting. He considered that accounting should focus upon the entity itself, in contrast to focusing on the interests of owners (61). Anthony maintained that the proprietary view had been superseded by the entity view in the literature, and that most writers now support the entity theory (61-62, 91). Anthony noted that despite this support for the entity theory in the literature, current

practice and the FASB conceptual framework are consistent with the proprietary theory rather than the entity theory (62, 92).

Anthony noted that under the entity theory, the accounting equation is: Assets = Equities (62). However, Anthony's entity theory is somewhat different from the entity theory described previously. Anthony considered that the "equities" did not reflect the interests or rights of the various parties in the entity (93). Instead he viewed "equities" as representing sources of funds. Anthony stated that the accounting equation is as follows:

Assets = Sources of Funds (93)

Anthony also did not view all equities as being claims or obligations (92). Specifically, Anthony did not consider shareholders' equity to be an obligation, which could be said to be inconsistent with the entity theory, where all equities are usually regarded as obligations. However, Anthony viewed "equities" as representing the sources of funds provided to the entity, rather than the financial interests of the equity holders, as is illustrated by his discussion of shareholders' equity:

> ...the amount reported as common shareholder equity is not a claim and does not reflect the financial interests of the common shareholders in any meaningful sense. The common shareholders cannot claim the amount stated as their equity...without destroying the entity...since the left-hand side of the balance sheet does not show the fair value of the assets, the balancing amount on the right-hand side does not represent the monetary amount of the shareholders' claim, equity, or rights (92).

Anthony suggested three classes of "equities" be presented in the balance sheet: liabilities, shareholder equity and entity equity. He described liabilities as being the funds provided by lenders, vendors (accounts payable), employees, and the government (deferred taxes) (93). Shareholder equity was stated to consist of the funds supplied by shareholders (paid-in capital), plus unpaid equity interest. Anthony considered that interest should be

provided for on the capital contributed by shareholders, and that unpaid equity interest was a source of funds in the same manner as unpaid debt interest (93). Anthony's third source of funds, entity equity, consists of funds generated by the entity's own efforts. Anthony noted that this does not correspond to retained earnings as calculated by current practice, because current practice does not recognise equity interest as an expense (94).

Anthony considered that liabilities and shareholders' equity were fundamentally similar in nature (99). This may seem inconsistent with his view, as noted earlier, that shareholders' equity is not an obligation, which suggests that there is some fundamental difference between liabilities and shareholders' equity. However, it must be recalled that Anthony focused upon equities as sources of funds, not as claims or obligations. Thus, he did not consider that it was necessary to clearly distinguish between the two categories (100). Instead, he considered that the distinction between internally sourced funds (entity equity) and externally sourced funds (liabilities and shareholder equity) was a more basic distinction (101).

6.3.3 Summary

Both Paton (1922) and Anthony (1983) clearly supported the entity theory. However, there are some differences in their approach to "equities". Paton (1922) viewed "equities" as representing financial interests in the entity, while Anthony (1983) viewed "equities" as being sources of funds. Each had a different approach to dividing "equities" into classes. Also, Anthony's notion of "equity interest" was not a feature of Paton's views, implying a different approach to allocating income amongst the various types of equities.

6.4 Residual Equity Theory

Authors selected for this chapter who appear to have supported the residual equity theory are Paton and Dixon (1958) and Chambers (1966). It may be noted that Paton (1922) appeared in the previous section on the entity theory, while his later work, Paton and Dixon (1958), appears in this section. This suggests that Paton modified his ideas between 1922 and 1958.

Table four is a summary of the main features of the residual equity theory:

TABLE FOUR
RESIDUAL EQUITY THEORY

Entity/proprietors' relationship	Entity exists in its own right, separate from the proprietors
Financial reporting focus	Residual equity holders
What are "liabilities"?	Fixed interests - obligations of the entity that require it to transfer definite sums to other parties outside the entity, including proprietors if their interest is fixed (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
What is "equity"?	Variable residual interest, that is, the lowest-ranking obligation that is indefinite in amount, as it represents the claim to the residue of the assets that remain after deduction of "liabilities", as determined above.
Is "equity" an obligation of the entity?	Yes
Treatment of transfers to/from proprietors	Reciprocal
Treatment of returns payable on investments by various parties having a financial interest in the entity	Expense if in respect of "liabilities", distribution of income if in respect of "equity"

6.4.1 Paton and Dixon (1958)

Paton and Dixon presented a "Position Statement" with two main categories: assets and "equities" (12). They described equities as being the total of all recognisable claims or rights to the resources of the entity (29). This view is contrary to the proprietary theory, which does not consider proprietors' equity to be in any sense a claim (obligation) of the entity (Bird et al. 1974). Clearly, Paton and Dixon did not support the proprietary theory. Instead, their view of "equities" is more consistent with the entity or residual equity theories, both of which view all financial interests as being claims (obligations) of the entity.

Paton and Dixon divided "equities" into two classes, "liabilities" and "proprietary equities", and distinguished between them:

> The persons having a financial stake in a business enterprise are often referred to as "insiders" and "outsiders", with the insiders being the more-or-less permanent owners, supplying the basic capital and controlling the over-all operations of the company, while the outsiders supply capital, for either current or long-term purposes, but do not ordinarily have a voice in the direction of the enterprise. Outsider claims against the business are known as *liabilities* (24).

This description of liabilities and proprietary equities as being the interests of "insiders" and "outsiders" is not consistent with the entity theory, which does not draw any fundamental distinction between the various equity holders' interests.

Paton and Dixon described liabilities as an obligation representing a definite amount payable to a specified person or persons (p. 24). In contrast, the proprietary interest is described as the ownership stake in the enterprise which represents "the residual or 'balancing' equity" (28). Thus, Paton and Dixon's approach to liabilities and proprietary equities appears consistent with the residual equity theory.

Liabilities and proprietary equities are also distinguished by the ranking of their claims. Liabilities are described as being superior or senior claims, while proprietary equities are described as being junior (29).

In summary, there appears to be three criteria used by Paton and Dixon to distinguish between "liabilities" and "proprietary equities":

- Liabilities are fixed interests while proprietary equities are the variable residual;
- Liabilities represent senior claims to the entity's assets while proprietary equities are junior claims, ranking below liabilities;
- The proprietary equity holders control the entity's operations, while liability holders do not have any such control.

They commented on the difficulty of distinguishing between creditor and proprietary interests in the case of companies:

> In some cases the factors of risk, control, and other fundamentals of ownership are so apportioned among the various classes of investors that it is difficult to distinguish the proprietary interest on the basis of precise legal definition (28).

Paton and Dixon did not discuss this matter in greater depth, which is somewhat surprising given the emphasis they placed upon the distinction between liabilities and proprietary equity. For instance, they commented upon the importance of the relationship between the entity's total equity and total assets, as an indicator of financial strength (747).

Paton and Dixon had difficulties determining how preferred stock should be classified. At one point they suggested that preferred stock was part of equity, even though the contractual rights of preferred stockholders were similar to those of creditors (748). Given their discussion of proprietary equities as being residual rather than fixed interests, one

would expect preferred stock - assuming it is non-participating - to be classified as liabilities rather then equity.

Paton and Dixon commented upon preferred stock as follows:

> ...many preferred issues...are stocks in name only. That is, such issues represent contractual, senior capital and are more closely allied to bond issues than to the risk-bearing, proprietary equity represented by the common stockholders (595).

This suggests that in some cases, preferred stock should be classified as liabilities rather than as proprietary equities, yet Paton and Dixon do not present preferred stock in this manner.

Paton and Dixon's indecision about whether preferred stock should be classified as liabilities or as proprietary equities is best illustrated in their example of a company position statement. This showed preferred stock as a separate amount, following current liabilities and long-term liabilities, but before common stockholders' equity (379). Their explanatory notes on this presentation comment:

> Where preference capital stock is outstanding the amount thereof should be displayed in an intermediate position between the liability total and the common stockholders' equity section (377).

The intermediate position of preferred stock is not consistent with the earlier classification of all equities into "insiders" (proprietary) interests and "outsiders" (creditors) interests. Preferred stock appears to be in limbo between the two types of interests.

6.4.2 Chambers (1966)

Chambers considered that the statement of financial position was divided into two main categories: assets and "equities". Chambers discussed equities as being contractual obligations or rights. He divided these obligations into two classes: liabilities and residual equities (105). Chambers used the term "residual equities", which he attributed to Paton (1922), to refer to "obligations to the constituents of an association", while obligations to creditors were termed liabilities (105). The view of all financial interests as obligations is consistent with both the entity and residual equity theories and inconsistent with the proprietary theory. The division of equities into two classes, liabilities and residual equity, appears to be more consistent with the residual equity theory, but is also consistent with the entity theory, as some entity theorists also prefer to divide equities into these two classes (Bird et. al 1974).

However, Chambers did not subscribe to the entity theory view of the residual equity holders as being merely one class of parties having an interest in the entity, of no more importance than the other parties who have a financial interest. Chambers viewed the entity as an association of natural persons, whose capacity to act is derived from, and for the benefit of, those persons:

> The capacity of associations to engage in exchanges originates in contributions, of money or in kind, by natural persons. These constituents of an association acquire rights by virtue of their contributions, rights to determine what it shall do, how its affairs shall be supervised, and how its proceeds shall be divided...the rights and powers vested in associations are so vested for the benefit of the constituents (105).

This focus upon the "constituents of the association", the residual equity holders, is consistent with the residual equity theory, rather than the entity theory.

That Chambers supported the residual equity theory is further illustrated by his discussion of residual equity and liabilities. Chambers discussed residual equity as being of an uncertain amount, dependent upon the results of operations (106). Liabilities are discussed as being determinable with greater precision than residual rights and as being senior claims, ranking ahead of residual equity (106-107). Also, Chambers discussed the term "capital" as being the residual equity, and proposed a capital maintenance adjustment to account for the impact of price changes on residual equity. Income, costs, gains and losses are described as being changes in residual equity (122). This focus on residual equity is consistent with the residual equity theory.

6.4.3 Summary

Paton and Dixon (1958) discussed liabilities as being fixed prior interests and equity as the variable residual interest, consistent with the residual equity theory. However, they appeared uncertain as to how certain financial interests, namely preferred stock, should be classified. At various points they suggested that preferred stock should included in equity, or in liabilities, or in limbo between liabilities and equity. Paton and Dixon's distinction between liabilities and equity was therefore inconsistent.

Chambers (1966) also discussed liabilities as fixed interests and equity as the variable residual interest, consistent with the residual equity theory. He focused upon the interests of the "constituents of the association" - the residual equity holders - and defined income in terms of changes in residual equity. This is consistent with the residual equity theory.

6.5 Entity/Proprietary Theory Variation

Just as the residual equity theory falls somewhere between the entity and proprietary theories (Hendriksen 1977), so too does another equity theory followed by a number of authors. As will be shown below, this theory is similar in many respects to the proprietary theory, and thus could be viewed as being a "modified" proprietary theory. However, it has a distinctly different approach to why equity is not considered to be an obligation of the entity, and it also has some features in common with the entity and residual equity theories. Consequently, it may be clearly differentiated from the proprietary theory.

This theory has not previously been identified as a distinct equity theory, so has received almost no attention in the accounting literature. Its existence was discovered while reviewing authors for inclusion in this chapter. Although hardly discussed in the literature, this other theory seems to have existed since at least early this century, and a considerable number of authors seem to follow this theory, which indicates that it has a significant level of support.

By analysing the discussion of equity and liabilities by the authors presented below, it is possible to derive the main features of this equity theory:

- In common with the entity and residual equity theories, the entity is viewed as existing in its own right, separate from the proprietors;
- In common with the proprietary theory, the financial reporting focus is the proprietors or owners;
- "Liabilities" consist of obligations that compel the entity to transfer resources to other parties outside of the entity, including the proprietors/owners, where they have a

legally enforceable claim, such as declared dividends (the entity exists separately from the proprietors, so proprietors are "outside" of the entity);

- "Equity" is viewed as being either the *residual* interest - that is, the interest in the *residue* of the assets that remain after deduction of "liabilities" as determined above - or the proprietors' net interest - that is, the proprietors' *gross* interest in *all* of the assets *less* 'liabilities" as determined above;
- "Equity" is not considered to be an obligation of the entity, because the entity is not compelled to transfer resources to proprietors (owners) prior to some formal act, such as the declaration of a dividend, except in the event of the entity winding up;
- Transfers to/from proprietors (owners) are viewed as being non-reciprocal. For example, contributions by owners do not increase the entity's obligations - because equity is not considered to be an obligation - nor does the entity give up any resources. Consequently, the entity gives nothing in exchange for the contributions by owners. Similarly, it receives nothing in exchange when it makes a distribution to owners;
- Returns payable on investments are treated as expenses to be included in the calculation of net income if the returns relate to "liabilities", and as a distribution of net income if the returns relate to "equity".

It can be seen that this theory has many features in common with the proprietary theory, such as the focus on the proprietors/owners, the view that equity is not an obligation, and the view that transfers between the proprietors/owners and the entity are non-reciprocal. However, this theory also views the entity as existing separately from the proprietors/owners, contrary to the proprietary theory. This impacts upon the reason why equity is not viewed as an obligation, which differs from the proprietary theory reason. Under the proprietary theory, the entity is *not* considered to have its own existence, separate from the proprietors. Consequently, obligations exist where the entity is required to transfer resources to parties *other* than the proprietors. Under the theory detailed above,

the entity *is* considered to exist separately from the proprietors/owners. However, because the entity is not considered to be *compelled* to transfer resources to proprietors/owners prior to some formal act, such as the declaration of a dividend, equity is not considered to be an obligation. This reasoning is clearly different from that of the proprietary theory.

Various prominent authors appear to have followed this theory, including Hatfield (1909), Canning (1929), Sprouse and Moonitz (1962) and Kerr (1989). Their discussion of liabilities and equity is reviewed below.

6.5.1 Hatfield (1909)

Hatfield began his discussion of accounting by presenting a basic accounting equation:

The value of the various Goods one owns = The amount one is worth.
Or
Goods = Proprietorship (1)

Hatfield described liabilities as negative goods, while assets were described as positive goods (14). Consistent with this view, he later described liabilities as negative assets, which "differ radically from capital" (185). Hatfield criticised the practice of labelling one side of the balance sheet "liabilities" as he considered that the capital or proprietorship accounts were not liabilities of the company or individual proprietor (43-44). Therefore, it seems that Hatfield followed the proprietary theory, particularly with respect to the view of that theory whereby proprietors' equity is not considered to be an obligation of the entity, and therefore is fundamentally different from liabilities. Furthermore, Hatfield described proprietorship as being *net* wealth. He stated that the proprietors owned *all* of the entity's assets, and that proprietorship was the net of assets less liabilities (14). This view of the proprietors' interest in the assets of the entity is consistent with the proprietary theory.

Hatfield also followed the proprietary theory when discussing net income. For example, he presented an income statement that showed interest on debt as an expense deducted in arriving at net income, while dividends to stockholders were treated as a distribution of income (280).

However, in his discussion of companies, Hatfield made a number of comments that indicate an approach different from the proprietary theory. For example, he commented that when a dividend is declared it becomes a liability (193). Under the proprietary theory, the entity is not considered to exist separately from its proprietors. Consequently, the entity's obligations are limited to those that involve parties other than the proprietors. Liabilities represent the entity's obligations, therefore, proprietors' financial interests are not liabilities. To treat a declared dividend as a liability appears inconsistent with the proprietary theory.

Also, Hatfield stated that undivided profits were not a liability, the stockholders had no right to *compel* their distribution, and that this corresponds to the *legal position* (193, emphasis added). The reason why Hatfield considered undivided profits were not a liability appears to rest upon the stockholders' inability to compel their distribution. Under the proprietary theory, undivided profits are part of proprietors' equity, which is not a liability because the entity is not considered to exist separately from the proprietors. Hatfield's reason why undivided profits are not a liability is therefore different from the proprietary theory reason, as it seems to rest on the legal position of stockholders rather than the view that the entity does not exist separately from the stockholders. Indeed, by stating that stockholders cannot compel the distribution of undivided profits suggests that it is the corporation itself, not the stockholders, who determines whether distributions to stockholders should be made. This indicates that the corporation exists in its own right,

separate from its stockholders, which is not consistent with the proprietary theory. Instead, it is more consistent with the entity or residual equity theory, which both view the entity as existing in its own right. However, under both the entity and residual equity theories all financial interests are obligations, while Hatfield did not consider that the proprietors' interest was an obligation of the corporation (43).

In summary, Hatfield's approach seems to be some combination of certain aspects of the entity and proprietary theories - that the entity exists in its own right (as per the entity theory) but proprietors'/stockholders' equity is not a liability or obligation of the entity (as per the proprietary theory). Notably, the reason why stockholders' equity is not a liability or obligation of the entity is not based upon the proprietary theory, but instead rests upon the lack of compulsion that the corporation is under to make distributions to stockholders. Under this approach, "liabilities" will be financial interests where the entity is compelled to transfer resources to the holders of such financial interests, such as where there is a legally enforceable claim, as with declared dividends, while "equity" will consist of those financial interests where no such compulsion exists.

It appears that Hatfield assumed that the financial interests classified as "equity" under this approach were those of the proprietors, given his accounting equation shown above, which describes equity as "proprietorship".

6.5.2 Canning (1929)

Canning began his discussion of liabilities and net proprietorship by questioning whether the accounting equation "assets equal liabilities plus net proprietorship" means that there are "three classes of unlike things the valuations of which always stand in a certain equivalent relation" (47). He suggested that the accounting equation consists of two things

only, and that those two things are not assets and claims running against the assets, but are instead:

> (1) the assets in their relations favourable to their proprietor, and (2) claims of others adverse to the proprietor of the enterprise in question (47).

Canning defined the term "proprietor" as a "holder of assets" (48). Canning defined liabilities as follows:

> A liability is a service, valuable in money, which the proprietor is under an existing legal (or equitable) duty to render to a second person... (55-56)

Initially, it appeared that Canning followed the proprietary theory, with the focus being on the proprietor. Canning viewed liabilities as obligations of the proprietor, while equity (net proprietorship) was not considered to be an obligation, which is consistent with the proprietary theory (Gynther 1967). Canning clearly considered liabilities and net proprietorship to be fundamentally different in concept, consistent with the proprietary theory, as indicated in the following comments:

> In the matter of valuation, liabilities do not differ from assets except in characteristic direction of flow. Those writers who urge consideration of liabilities as negative assets express a view more fruitfully suggestive than do those who habitually associate liabilities and net proprietorship in their discussion (50-51).

Canning also discussed the determination of net income in a manner consistent with the proprietary theory. He considered that deductions from gross income in arriving at net income consisted of disbursements that were "adverse to the proprietor's interests" (127). He specifically considered the case of dividends, and concluded that dividends were dispositions of net income rather than deductions included in the determination of net income (132). This is consistent with the proprietary theory, which treats distributions to

proprietors, such as dividends, as an allocation of net income rather than an expense to be included in arriving at net income. Canning also mentioned "payments of interest" as one example of disbursements that are deductions from gross income in the determination of net income (128). This is also consistent with the proprietary theory, which treats as an expense the returns payable on financial interests that are classified as liabilities.

Canning's discussion of liabilities, equity (net proprietorship), and income determination therefore *appears* consistent with the proprietary theory. However, in his discussion of debenture bonds, Canning treated the corporation as the proprietor:

> The proprietor in question is presumably a corporation...so long as the corporate entity exists, or as long as the objects for which the corporation became a proprietor exist, no claim can be enforced under this contract...Legally the "bonds" may be debts; but they lack the economic attribute of adverseness to the proprietor's interest (62).

Essentially, by treating the entity as the proprietor, Canning appears to have adopted the entity theory viewpoint of the entity as existing in its own right, and then applied the proprietary theory to the entity (Chow 1942). This is consistent with his approach to liabilities as being obligations of the proprietor (the entity) while net proprietorship is not a liability of the entity (61). Canning made the following comment on equity (net proprietorship):

> Net proprietorship cannot be qualitatively defined except as a mere difference. It is the difference found by subtracting the summation of the liabilities from the amount of the proprietorship (55-56).

Canning's definition of net proprietorship could be seen as a description of the *measurement* of net proprietorship, rather than the *concept* itself (Kerr 1989). However, it is consistent with Canning's assertion that the accounting equation consists of two things not three: proprietorship (the proprietors' interest in the assets) and liabilities (claims

against the proprietors). In effect, Canning did not have a concept for equity (net proprietorship); he considered it to be merely a difference between proprietorship (assets) and liabilities.

Canning stated that when considering how a particular item should be classified, the question should not be whether the item is a liability or a net proprietorship item; instead "the significant inquiry is rather is the item a liability or not a liability? Is the claim represented adverse to the interest of the proprietor?" (61). Canning distinguished liabilities from equity by the fact that liabilities impose a claim against the entity whereas equity does not. As to the nature of the claim, Canning clearly considered that the economic substance of the claim took precedence over the legal form of the claim in determining whether a claim was a liability for accounting purposes, as can be seen in his discussion of debenture bonds noted above. He further commented:

> All liabilities in the accounting sense are debts in the legal sense, but the converse is not true (63).

In Canning's view, therefore, financial interests should be classified according to the economic substance rather than the legal form of particular financial interests, and that, as a consequence, the accounting definition of liabilities is *narrower* than the legal definition of liabilities - all accounting liabilities are legal liabilities, but not all legal liabilities are accounting liabilities.

6.5.3 Sprouse and Moonitz (1962)

Sprouse and Moonitz at first appeared to have followed the proprietary theory. For instance, they discussed the determination of net income (net profit) in accordance with the proprietary theory. Net profit was stated to be the amount of the increase in owners' equity, excluding price-level changes and contributions by and *distributions to* owners.

This indicates that returns on investments that are classified as liabilities are included as expenses in the determination of net profit, while returns on owners' investments are treated as distributions of net profit. This conclusion is further supported by the mention of interest as an example of an expense (49) and the discussion of net profit as an addition to retained earnings while dividends are a deduction from retained earnings (43).

Also, Sprouse and Moonitz considered that proprietors' equity (which they termed "owners' equity") is not an obligation of the entity (38). This is consistent with the proprietary theory. However, the reason why owners' equity is not an obligation differs from the reason under the proprietary theory. Under that theory, the entity is not considered to exist separately from the proprietors, hence the entity's obligations are limited to the financial interests of parties other than the proprietors. Sprouse and Moonitz do not give this as the reason why owners' equity is not an obligation of the entity. Instead they stated:

> The owners' equity does not constitute an obligation because, ordinarily, the business enterprise is not legally or equitably compelled to provide payments or services to owners other than by the decision of the owners or their representatives (38).

This approach is similar to Hatfield (1909) and Canning (1929) in that liabilities are distinguished from equity on the basis that the entity is not *compelled* to make distributions to owners. Sprouse and Moonitz also took the same view as Hatfield (1909) whereby declared dividends are considered to be a liability, as the declaration "creates an obligation...which is no longer within the control of the business enterprise" (38). Again, this is not consistent with the proprietary theory, as that theory limits obligations to those financial interests that involve parties other than the proprietors (owners), hence a dividend to be paid to the proprietors cannot be a liability under the proprietary theory. Furthermore, Sprouse and Moonitz seem to suggest that the declaration of the dividend transfers *control* of those resources from the entity to the owners, which indicates that the

entity is considered to exist in its own right, separate from the owners. The proprietary theory considers that the entity does *not* exist in its own right, so *all* resources of the entity are controlled by the proprietors (owners), not merely declared dividends.

Sprouse and Moonitz defined liabilities as obligations or claims against the entity, that require the entity to 'convey assets or perform services', that have a 'known or reasonably determinable maturity date', and 'an independent value which is known or reasonably measurable' (37) They considered that their definition of and comments on liabilities was consistent with the legal view of liabilities (37).

Sprouse and Moonitz described owners' equity as the residual interest in the assets of an enterprise (38). This is similar to the residual equity theory view of equity, where equity is considered to represent the claim to the residue of the assets, after deduction of all prior claims to the entity's assets (Staubus 1959). Such a view contrasts with the proprietary theory view, whereby the proprietors are considered to own *all* of the entity's assets, not merely have a claim to the residue.

Sprouse and Moonitz stated that owners' equity could be distinguished from liabilities on two grounds. The first ground appears consistent with the residual equity theory, where liabilities are fixed interests and equity is the residual interest:

> First, the amount of the owners' equity is residual in nature while the maturity values of liabilities are independently determined (38).

However, the second ground, set out below, adopted a different approach:

> Second, liabilities are in a continuous and irresistible process of maturing while owners' equity matures only at the volition of the owners of the business enterprise or their representatives or upon ultimate liquidation. Thus liabilities are obligations, the amounts and maturities are not solely within the control of the business enterprise. The owners' equity does not constitute an obligation because, ordinarily, the business enterprise is not legally or equitably compelled to

> provide payments of services to owners other than by the decision of the owners or their representatives (38).

This description of liabilities as obligations and owners' equity as not being an obligation is consistent with the proprietary theory. However, as noted above, the reasoning behind why owners' equity is not considered to be an obligation is different from the proprietary theory.

Effectively, Sprouse and Moonitz described two inconsistent grounds for distinguishing between liabilities and owner's equity. For example, non-participating non-redeemable preferred stock would be classified as a liability under the first ground (as a fixed interest), and as owners' equity under the second ground (as there is no obligation to repay the funds contributed until liquidation).

6.5.4 Kerr (1989)

Kerr examined the concept of equity as part of a project undertaken by the Australian Accounting Research Foundation to develop a conceptual framework for financial reporting (1).

Kerr referred to equity as "owners' equity" in her discussion of business entities in the private sector. According to Kerr, "owners" are those who bear the greatest financial risk. This is determined by "the extent to which the return on that investment is affected by enterprise operations" (39). She stated that the characteristics of equity are: equity ranks below liabilities as a claim to the entity's assets; and equity bears the risks and rewards of operations and other events affecting the entity (72).

Initially, Kerr's approach to equity appears consistent with the residual equity theory, where liabilities are fixed prior interests and equity is the variable residual interest. If equity bears the risks and rewards of operations, then clearly *fixed* interests (that is, non-participating interests) would be excluded from equity, implying that equity is a *variable* interest, consistent with the residual equity theory. Also, by identifying owners as those who bear the greatest risk, and describing equity as the lowest ranking claim to the entity's assets, Kerr also implied that equity is a *residual* interest, and that "owners" are the claimants to the *residue* of assets that remain after deduction all prior claims to the assets, which is in accordance with the residual equity theory (Staubus 1959).

Kerr defined equity as:

> ...the residual interest in the assets of an entity; the residual interest is the interest in the assets of an entity that remains after deducting its liabilities (72).

and liabilities as:

> ... the future sacrifice of economic benefits that an entity may be required to make in satisfaction of a present obligation to transfer assets or provide services to other entities as a result of past transactions or events (25).

This liabilities definition was taken from an earlier study, where it was noted that "the obligation is such that legal, moral or economic sanctions allow the entity little or no option to avoid future settlement" (Kerr 1984, p. 25). It is clear that this definition of liabilities is not in accordance with the residual equity theory, as it appears to include *all* obligations, rather than *fixed* obligations. Also, under the residual equity theory, equity is considered to be an obligation. Kerr, however, defined equity as the residual interest after deduction of liabilities, and liabilities as being *all* obligations, implying that equity is *not* an obligation:

> A company is obligated to transfer assets to its shareholders *only after the formal declaration of a dividend (when it becomes a liability)*, or in the event of the company's liquidation (27, emphasis added).

The above definitions of equity and liabilities are consistent with the proprietary theory only in so far as liabilities are obligations and equity is not an obligation. The *reason* why liabilities are obligations, and equity is not, is not consistent with the proprietary theory. That theory considers that the entity does not exist separately from its owners, so the entity's obligations are to parties other than proprietors. Hence, proprietors' dividends would not be a liability under the proprietary theory. Also, the proprietary theory considers that the proprietors own *all* the entity's assets, not merely the *residual*, as is implied by Kerr's definition of equity.

Kerr's approach seems to be that liabilities place some *compulsion* on the entity to transfer resources, as noted by the comment that liabilities are obligations that allow the entity "little or no option to avoid future settlement". Under such an approach, liabilities are those financial interests whereby the entity is *compelled* to transfer resources to the holders of such interests, such as in the case of declared dividends. Equity, being the residual (assets minus liabilities), consists of the remaining financial interests that do *not compel* the entity to transfer resources to the holders of such interests. Therefore, Kerr's definitions of liabilities and equity adopt a "compulsion versus non-compulsion" approach, similar to the approach of Hatfield (1909), Canning (1929), and Sprouse and Moonitz (1962). This seems inconsistent with her initial discussion of equity, which appeared consistent with the residual equity theory.

Kerr's inconsistency in her approach to equity is demonstrated by her discussion of equity in the context of private sector business entities, particularly in her review of company financing arrangements such as preference shares and convertible debt securities. In the case of preference shares, Kerr concluded that if such shares did not participate in

company profits nor in the surplus assets upon winding up, then such shares were more like debt than equity. This distinction between liabilities and equity appears to be based upon whether the return on the shares is fixed or variable, and whether the preference shareholders are claimants to the residue of the entity's assets, which is consistent with the residual equity theory. However, Kerr also noted that if preference shares had a fixed redemption date or were redeemable at the option of the shareholder, then these shares should be classified as liabilities (41-44), and she considered convertible debt securities should be classified as equity, where it was probable that debt would be converted into shares (46). This distinction between liabilities and equity appears to be based upon whether or not the entity is compelled to transfer resources to the preferences shareholders/debt holders. Such a distinction is not consistent with the residual equity theory, but is instead consistent with Kerr's "compulsion versus non-compulsion" definitions of liabilities and equity.

6.5.5 Summary and Discussion

Hatfield (1909), Canning (1929), Sprouse and Moonitz (1962), and Kerr (1989) all focused upon the interests of the proprietors or owners, consistent with the proprietary theory. They viewed liabilities as obligations of the entity, while proprietors' equity was not considered to be an obligation of the entity, consistent with proprietary theory. However, their reason for viewing equity as not being an obligation differed from the proprietary theory. Under that theory, the entity is not considered to exist separately from the proprietors. Hence the entity's obligations to parties outside of the entity necessarily excludes proprietors, as proprietors are not "outside" of the entity. Hatfield (1909), Canning (1929), Sprouse and Moonitz (1962), and Kerr (1989) did not follow this line of reasoning. Instead, they adopted the entity theory viewpoint of the entity as existing

separately from the proprietors. They then reasoned that while liabilities impose an obligation on the entity to transfer resources to another party - which may include proprietors in the case of declared dividends - equity was not an obligation as it did not impose any such compulsion on the entity.

There was some variation between these authors as to which particular financial interests would be classified as liabilities and which would be classified as equity under this "compulsion versus non-compulsion" approach to the distinction between liabilities and equity. Both Hatfield (1909) and Sprouse and Moonitz (1962) considered that their approach to liabilities agreed with the legal view of liabilities. In contrast, Canning (1929) adopted a narrower view of liabilities, as he considered that there were some financial interests that were legally debts but were not necessarily liabilities for accounting purposes. Sprouse and Moonitz (1962) also specified a second ground for distinguishing between liabilities and equity that is consistent with the residual equity theory rather than the "compulsion versus non-compulsion" approach. Similarly, Kerr (1989) classified certain financial interests according to the residual equity theory and others according to the "compulsion versus non-compulsion" approach.

Another variation between these authors is that Hatfield (1909) and Canning (1929) adopted the proprietary theory view of the proprietors' interest in the entity's assets, that is, the proprietors are considered to own *all* of the entity's assets. In contrast, Sprouse and Moonitz (1962) and Kerr (1989) described proprietors'/owners' equity as the *residual* interest in the entity's assets, consistent with the residual equity theory, where the proprietors are viewed as claimants to only the *residue* of the entity's assets that remain after deduction of the prior claims to the entity's assets.

Hatfield (1909), Sprouse and Moonitz (1962), and Canning (1929) agreed upon the determination of net income. These authors considered that interest on debt is to be treated as an expense/deduction that is included in the determination of net income, while dividends to proprietors/owners are to be treated as a distribution of net income. As Kerr's (1989) discussion was limited to the concept of equity, she did not comment upon determining income.

6.6 Summary and Conclusion

The distinction (if any) drawn between liabilities and equity by the various authors depends mostly upon their approach to equity. Some authors were clearly in favour of one particular known equity theory: Sprague (1909) adopted the proprietary theory; Paton (1922) and Anthony (1983) adopted the entity theory; and Paton and Dixon (1958) and Chambers (1966) followed the residual equity theory.

A surprising number of authors appeared to have adopted another equity theory, that has received little specific attention in the literature. This other equity theory seems to have existed for some time and to have considerable support, including Hatfield (1909), Canning (1929), Sprouse and Moonitz (1962) and Kerr (1989). This theory is similar to the proprietary theory in many respects, but may be differentiated from the proprietary theory in its view of the entity as existing separately from the proprietors/owners, and its reasoning that equity is not an obligation because the entity is not *compelled* to transfer resources to the equity interest holders. The distinction between "liabilities" and "equity" will therefore rest upon an assessment of whether particular financial interests *compel* the entity to transfer resources to those interest holders. This differs from the proprietary theory, which considers that the entity does not exists separately from the proprietors, and

hence liabilities are obligations to parties other than the proprietors, and equity is the proprietors' net interest.

Hatfield (1909), Sprouse and Moonitz (1962), and Kerr (1989) appear to consider that the financial interests classified as equity under this "compulsion versus non-compulsion" approach will be the proprietors' or owners' interests, but the validity of this presumption could be challenged. Certainly, Canning (1929) did not view equity (net proprietorship) in this manner, as he considered it to be merely the difference between assets and liabilities. Specifically, he commented that certain legal debts, such as debenture bonds, were not liabilities for accounting purposes - and were therefore to be classified as equity - which means that "equity" represents something other than the interests of proprietors or owners. Whether equity represents the proprietors/owners interests under the non-compulsion equity theory will be examined in greater detail in chapter nine.

Table five summarises the various equity theories discussed in this chapter. For convenience, the approach to liabilities and equity followed by Hatfield (1909), Canning (1929), Sprouse and Moonitz (1962), and Kerr's (1989) definitions of liabilities and equity, shall be termed the "non-compulsion equity theory". The variation between these authors concerning their view of the proprietors' claims to the entity's assets is also noted.

One feature of the non-compulsion equity theory noted in table five, but not previously mentioned, is its view of transfers between the entity and the owners. It follows that because owners' equity is not an obligation of the entity, transfers of resources to/from the owners must be viewed as being non-reciprocal. Such transfers would be non-reciprocal as they result in an increase/decrease in the entity's assets (being the resources transferred from/to the owners) without a corresponding increase or decrease in the entity's total obligations (as the increase/decrease is to equity, which is not an obligation).

TABLE FIVE
COMPARISON OF EQUITY THEORIES - REVISED

	Proprietary Theory	**Non-Compulsion Equity Theory**	**Residual Equity Theory**	**Entity Theory**
Entity and proprietors relationship	Entity does not exist separately from the proprietors	Entity exists in its own right, separate from the proprietors	Entity exists in its own right, separate from the proprietors	Entity exists in its own right, separate from the proprietors
Financial reporting focus	Proprietors	Proprietors	Residual Equity Holders	Entity
What are "liabilities"?	Obligations of the entity to transfer resources from the entity to other parties outside of the entity, which necessarily excludes proprietors (the entity does not exist separately from the proprietors, hence proprietors are not "outside" the entity)	Obligations of the entity that compel it to transfer resources to other parties outside the entity, including proprietors where they have a legally enforceable claim, such as declared dividends (the entity exists separately from the proprietors, so proprietors are "outside" the entity).	Fixed Interests - Obligations of the entity that require it to transfer definite sums to other parties outside the entity, including proprietors if their interest is fixed (the entity exists separately from the proprietors, so proprietors are "outside" the entity).	No conceptual distinction from "equity" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
What is "equity"?	Proprietors' net interest, that is, the proprietors' gross interest in all the assets less "liabilities", as determined above.	Residual interest, that is, the interest in the residue of the assets that remains after deduction of "liabilities", as determined above. OR Proprietors' net interest, that is, the proprietors' gross interest in all the assets less "liabilities", as determined above.	Variable residual interest, that is, the lowest-ranking obligation that is indefinite in amount, as it represents the claim to the residue of the assets that remain after deduction of "liabilities", as determined above.	No conceptual distinction from "liabilities" - all financial interests represent obligations to transfer resources from the entity to other parties outside of the entity, including proprietors (the entity exists separately from the proprietors, so proprietors are "outside" the entity).
Is "equity" an obligation of the entity?	No	No	Yes	Yes
Transfers to/from proprietors	Non-Reciprocal	Non-Reciprocal	Reciprocal	Reciprocal
Treatment of returns payable on investments by various parties having a financial interest in the entity	Expense if in respect of "liabilities", distribution of income if in respect of "equity"	Expense if in respect of "liabilities", distribution of income if in respect of "equity"	Expense if in respect of "liabilities", distribution of income if in respect of "equity"	All expenses or all distributions of income - no distinction between returns on investments of various parties

Some authors were inconsistent in their approach to equity. For example, Paton and Dixon (1958) appeared to follow the residual equity theory, but did not seem able to deal with the classification of preference shares. On some occasions they suggested that preference shares should be classified as debt, because these shares are often fixed interests, consistent with the residual equity theory. However, on other occasions they discussed preference shares as being part of equity, or something in between liabilities and equity. Kerr (1983) initially discussed the nature of equity in accordance with the residual equity theory. For example, she commented that equity bears the risks and rewards of operations - so is a *variable* interest - and ranks below liabilities as a claim to the entity's assets - so is the *residual* interest. However, Kerr defined liabilities and equity based upon the "compulsion versus non-compulsion" approach, where liabilities compel the entity to transfer resources to another party, while equity does not impose any such compulsion on the entity. Similarly, Sprouse and Moonitz (1962) were also inconsistent in their approach to liabilities and equity; they distinguished between liabilities and equity on two grounds, one of which was consistent with the residual equity theory - liabilities are fixed interests and equity is the variable residual - while the second ground followed the non-compulsion equity theory - liabilities compel the entity to transfer resources to other parties while equity does not.

In summary, this chapter demonstrated that there are various approaches to equity and its distinction from liabilities, including one variation, the non-compulsion equity theory, that, as an equity theory, has received almost no attention in the literature. Despite this lack of attention, the non-compulsion equity theory appears to have considerable support. Also, some authors appeared inconsistent in their approach to equity and liabilities. This indicates that a consistent and coherent conceptual distinction between equity and

liabilities requires that a conscious determination is made as to which equity theory should be adopted, and having made such a determination, applying that concept consistently.

CHAPTER SEVEN

VIEWS FROM ECONOMICS AND LAW

7.1 Introduction

Accounting does not exist for its own sake, but is a part of a wider environment:

> Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions...the objectives [of financial reporting] are affected by the economic, legal, political and social environment...(FASB SFAC1 1978, p.9).

The previous chapters demonstrated that the distinction between liabilities and equity requires consideration of the underlying equity theory, and that a variety of equity theories exist, including one theory that has received very little attention in the accounting literature, but which appears to have considerable support.

This chapter considers the accounting concepts of equity and liabilities in a wider context, from the perspective of the related fields of economics and law. Sections 7.2 and 7.3 discuss, respectively, the economic and legal approach to distinguishing between liabilities and equity, including a comparison to the various equity theories presented in the previous two chapters. The purpose of such a review is to establish which particular equity theory or theories have the most support, in legal and/or economic terms. Section 7.4 summarises this chapter.

7.2 The Economic Distinction between Liabilities and Equity

The economics literature has two basic approaches to liabilities and equity. Section 7.2.1 discusses the first approach: that there is no fundamental economic distinction between the two Section 7.2.2 considers the second approach: that there is an economic distinction

between liabilities and equity, which is relevant to financing decisions and investor decision-making.

7.2.1 The Distinction Does Not Exist/Is Irrelevant

Some authors consider that there is no fundamental economic distinction between liabilities and equity. For example, Berle and Means (1932) commented that while the law maintains a sharp dividing line between bondholders and stockholders, "*economically* the position of the two have drawn together" (246, emphasis added). They considered that all security holders have the same expectations: they expect to receive distributions, and they expect to receive a return of their capital, either from the corporation itself or by the resale of their security to someone else.

Edwards et al. (1979), after discussing liabilities and "ownership", considered that "too much of an issue" should not be made of the creditor/owner distinction (75). They commented that creditors and owners perform the same role, that of "renting" their capital to the company (75). Edwards et al. (1979) acknowledged that the degree of risk separates creditors from owners, because creditors' interests rank ahead of owners' interests, so carry less risk. However, they noted that ownership interests issued by one company may be less risky than debt instruments of another company. In general, therefore, the amount of risk borne by creditors and owners does not imply the existence of any fundamental distinction between them.

Similarly, Pope and Puxty (1991) argued that, from the economic perspective, there is no conceptual distinction between liabilities and equity. They based this view on the fact that all financial instruments carry some element of risk. This risk is derived from the uncertainty of future cash flows associated with the return on, and of, the funds invested.

Equity, such as ordinary shares, bears more risk than debt, such as bonds, due to uncertainty as to the timing and amount of dividends compared to fixed-rate interest payable at agreed intervals. However, this is merely a difference in the degree of risk associated with each type of financial instrument, rather than any conceptual economic distinction between them (900).

Pope and Puxty (1991) also considered two economic models, namely the principal-agent model and the socio-economic coalition theory, to further support their view that there is no economic distinction between liabilities and equity. They concluded that in the case of large companies there will be "outside" shareholders - shareholders not engaged in the management of the company - who face agency problems similar to those of outside debt holders, being that the company's managers may not act in the shareholders/debtholders' interests. Similarly, their review of socio-economic coalition theory concluded that all coalition partners, including shareholders and debtholders, need inducements to remain in the coalition.

The authors reviewed above argued against the *existence* of any fundamental economic distinction between liabilities and equity. This supports the entity theory, which considers that liabilities and equity are conceptually the same. Further support for the entity theory in the financial economics literature, from another perspective, is provided by those authors who argue that the liabilities/equity distinction, if such a distinction exists, is *irrelevant* to financing and investing decisions. Given that financial reports are intended to provide information useful for making such decisions (FASB SFAC1 1978), then if the distinction is irrelevant, there is little point in drawing any such distinction.

The most prominent financial economists who argued that the liabilities/equity distinction is irrelevant are Modigliani and Miller (1958), who laid the foundations of corporate

finance theory. They questioned the traditional view of gearing. According to the traditional view, debt is cheaper than equity, because debt offers investors returns of interest and principal on pre-specified terms, unlike equity. Hence, firms can increase their value and reduce their capital costs by raising their level of gearing, up to the point where the cheaper costs of debt are offset by the increased risk of bankruptcy. Contrary to this traditional view of gearing, Modigliani and Miller (1958) considered that a firm's capital structure was irrelevant to the firm's market value or its cost of capital (Clark 1993, Mayer 1992). They developed theorems demonstrating that, in the absence of taxation, and assuming perfect capital markets and no bankruptcy costs, the market value of the firm, and its average cost of capital, are completely independent of its capital structure (Mayer 1992). This implies that any distinction between liabilities and equity is irrelevant (Clark 1993).

7.2.2 The Distinction Exists/Is Relevant

There is criticism of the Modigliani-Miller theorems in the more recent financial economics literature. For example, Scott (1976) commented that if taxation is introduced into the Modigliani-Miller analysis, then the tax deductibility of interest would make debt cheaper, thereby implying that the firms' optimal capital structure consisted entirely of debt. He remarked that "an indefinite debt-equity ratio is inconsistent with both common sense and established practice" (33).

The consensus of the recent economics literature is that a firm's market value, and its cost of capital, *are* affected by its capital structure. The firm's systematic risk has been shown to be linearly related to the amount of the firm's leverage (Hamada 1969, Rubenstein 1973). Higher debt levels mean greater risk to common shareholders, in terms of returns on, and of, their investment. This higher risk results in common shareholders expecting

greater returns as compensation for bearing greater risk (Clark 1993). If a firm has to pay higher returns to common shareholders, compared to the returns paid to debtholders, then equity finance is more expensive to the firm than debt finance. Higher debt levels also increase the probability of incurring bankruptcy costs. This was demonstrated by Scott (1976), who developed a multiperiod model of firm valuation which indicated each firm has a unique optimal capital structure - that is, an optimal debt-equity ratio - that maximises the firm's value. This implies that there is a distinction between liabilities (debt) and equity, and that the distinction is relevant to financing decisions and investor decision-making.

The debt/equity distinction is also relevant to bankruptcy prediction models. For example Zavgren (1985) developed various bankruptcy models to generate a probability of failure and to test the significance of various financial attributes. He commented:

> Debt proved to be a significant characteristic and was consistently higher for ailing than for healthy firms (43).

The financial economics literature usually does not specifically define what is meant by "debt" and "equity". However, it is possible to ascertain some understanding of the meaning of "equity" from this literature. The discussion of the cost of equity finance indicates that "equity" consists of variable interests, that is, those interests whose return varies depending upon the profits of the entity concerned. For example, Ferguson et al. (1993) discussed the price of risk associated with equity finance, which arises from the variability of returns. If "equity" consists of variable interests, this is consistent with the residual equity theory, which distinguishes between liabilities and equity on the basis that liabilities are fixed interests, while equity is variable.

Some authors do specifically mention types of financial interests whose classification as "debt" or "equity" may be questionable. For instance, Reekie and Allen (1983) commented as follows:

> ...a company's capital structure could be defined as the structure of permanent financing of the company - in other words, the relative proportions of debt, preference and equity share capital plus reserves...The treatment of preference capital is a moot point; should it be placed with debt as a fixed payment commitment, or with equity on grounds that payment can be waived?...We shall simply define capital gearing as the ratio of the market value of a company's long-term debt and the market value of its equity capital plus reserves (170).

Reekie and Allen (1983) seem to be uncertain whether preference shares are a liability, based upon the fact that preference shares have a fixed return - which suggests support for the residual equity theory - or equity, because payment can be waived - which suggests support for the non-compulsion equity theory. It seems that Reekie and Allen (1983) did not resolve how to treat preference capital, but instead chose to ignore it. However, they did differentiate between preference share capital and "equity" share capital, implying that preference shares are not part of "equity".

Bates and Parkinson (1982) were more definite in their treatment of preference shares. They noted that such shares usually carry a fixed return. Bates and Parkinson (1982) stated:

> The capital gearing ratio of a company indicates the relative proportions of a company's variable and fixed-interest capital (p. 157).

They then set out two ways of calculating gearing ratios, each of which included preference shares with debenture debt as the numerator, being fixed interests, while "equity shares" or "equity share capital" were included in the denominator, being variable interests (p. 158). Again, this is consistent with the residual equity theory, where "liabilities" are fixed interests and "equity" is a variable residual interest. This classification of preference shares was also followed by Meeks and Whittington (1976).

They, in a discussion of company financing, classified preference shares as part of loan finance that received a "fixed level of remuneration", while "equity issues" consisted of ordinary shares (7).

In summary, the consensus of the recent financial economics literature is that the distinction between liabilities and equity exists, and is relevant to financing decisions and investor decision-making, as it impacts upon the firm's systematic risk, its cost of capital, its market value and its likelihood of bankruptcy. The distinction drawn appears largely consistent with the residual equity theory.

7.3 The Legal Distinction Between Liabilities and Equity

The legal approach to the distinction between liabilities and equity differs from the economic approach. For example, at law, all shares seem to be regarded as equity, regardless of their economic characteristics. For instance, Ross (1994) commented on auction market preferred shares as follows:

> At law, the share issues are equity capital and the interest paid a distribution. In the economic terms of stocks and flows, the stock is subordinated debt and the flow of interest pegged to debt market interest rates at the time of issue (47).

Similarly, Schwimmer (1995), in a discussion of fixed-rate perpetual preferred shares, stated:

> ...although the preferred carries a fixed coupon, just like debt, because of its official status as equity, a preferred sale does not add leverage to the...balance sheet (13).

The New Zealand Securities Commission (1989), when discussing capital structure and financial reporting in New Zealand, also supported the view that all shares are equity. This

approach is also followed by the New Zealand Securities Regulations 1983, which define an "equity security" as:

> ...any interest in or right to a share in, or in the share capital of, a company; and includes...a preference share, and company stock (s. 2(1)).

These regulations include convertible debt in the definition of a "debt security" (Securities Regulations 1983).

In summary, it appears that legally, all shares, including fixed-rate preference shares, are regarded as equity, while all other financial interests, including convertible debt, are liabilities. The legal distinction between equity and liabilities is therefore consistent with the proprietary theory (Pope and Puxty 1991). Under that theory, all shareholders, including preference shareholders, are viewed as owners and proprietors (Staubus 1959), while convertible debt holders are not owners or proprietors *until* their debt converts into shares.

The legal equity/liabilities distinction contrasts with the residual equity theory, where equity is the variable residual interest and liabilities are fixed prior interests. Therefore, fixed-rate preference shares are liabilities, not equity, under the residual equity theory. Likewise, the non-compulsion equity theory also does not accord with the legal distinction between liabilities and equity. The non-compulsion equity theory distinguishes between liabilities and equity on the basis that liabilities are financial interests that compel the entity to transfer resources to those interest holders, while equity consists of those financial interests where no such compulsion exists. Accordingly, convertible debt would be included in equity, not liabilities, if it was probable that the debt would convert to shares (Kerr 1989). Finally, the legal distinction between liabilities and equity is not consistent with the entity theory, which considers that all financial interests, whether they be shares or otherwise, are conceptually the same.

The legal treatment of all shares as equity, which is consistent with the proprietary theory, is a result of the origins of company law. For example, under United Kingdom's 1844 companies legislation, shareholders did not have limited liability - the company's debts were the debts of the shareholders, consistent with the proprietary theory (Pope and Puxty 1991).

Despite the legal view that all shares are equity, there are some instances where the term "equity" appears to be more narrowly defined, such that it is applied to the lowest ranking shareholders only, albeit seemingly unwittingly in some cases. For instance, Ross (1994), after commenting that preference shares are legally part of equity, stated:

> Lawyers concentrate on contractual rights attaching to the investment. An equity investment means that the investor is part-owner of the company and may receive periodic dividends plus a share of the net residue on liquidation. A debt investor is a creditor, receiving interest...and entitled to repayment of capital before the residue is returned to equity investors (48).

If "equity" investors are those investors entitled to the residue of assets on liquidation, and "debt" investors are those entitled to repayment before equity investors, this suggests that "equity" investors are the residual claimants to the assets. Therefore, it is the lowest ranking shareholders only, not shareholders generally, that are the "equity" investors.

Similarly, the New Zealand Securities Commission noted that, while the distinction between debt and equity was "wafer thin", the distinguishing characteristic of shares is that they carried the "residual risk, i.e. are deferred to creditors, secured and unsecured, in the hierarchy of claims upon the corporate assets" (7). Following this reasoning to its logical conclusion implies that, as only the lowest ranking shareholders carry the residual risk, then it is those shareholders who should be considered to be "equity" holders, not shareholders generally. For example, preference shareholders cannot be said to bear the

"residual risk", as they have a claim to the assets ranking above ordinary shareholders - except where there is insufficient assets remaining, after deducting prior claims, to repay the preference shareholders in full.

As a further illustration of this narrower legal view of "equity", consider the following comments extracted from a legal definition of "share":

> Share: an interest in an incorporated company...*ordinary shares constitute the risk capital (also called equity capital*), as they carry no prior rights in relation to dividends or return of nominal value. However, the rights they do carry are unlimited in extent: if the company is successful, the ordinary shareholders are not restricted to a fixed dividend (A Dictionary of Law: Oxford University Press 1994, emphasis added).

If "equity" investors are those shareholders who are the claimants to the residue of the company's assets after deducting all prior fixed claims, then their interest is a variable residual. This distinction between liabilities and equity is consistent with the residual equity theory.

This conclusion is further supported by the New Zealand Companies Act 1993. For the purposes of the statutory solvency test, which the directors must apply to proposed shareholder distributions before authorising such distributions, "liabilities" are defined as follows:

> *"Liabilities" includes* the amounts that would be required, if the company were to be removed from the New Zealand register after the distribution, to repay *all fixed preferential amounts payable by the company to shareholders*, at that time, or on earlier redemption (*except* where such fixed preferential amounts are expressed in the constitution as being *subject to the power of the directors to make distributions*); but ... does not include dividends payable in the future (s. 52(4)(b), emphasis added).

The inclusion of fixed preferential amounts in "liabilities" is consistent with the residual equity theory. However, the exception should be noted: it implies that if the fixed preferential amounts are payable *only* with the directors' authorisation, then these amounts

are not liabilities. This appears to be similar to the non-compulsion equity theory approach to liabilities and equity, where equity consists of those financial interests in relation to which the entity is not compelled to make distributions.

In summary, it appears that the legal distinction between liabilities and equity is that all shares, irrespective of their economic characteristics, are equity, while all other financial interests are liabilities. This distinction accords with the proprietary theory, and contrasts with the residual equity, entity and non-compulsion equity theories. However, there are instances where the term "equity" appears to be more narrowly defined, such that it applies to the lowest ranking shareholders, who are the claimants to the residue of the company's assets. This narrower application of the term "equity" is consistent with the residual equity theory.

7.4 Conclusion

This chapter considered the distinction between liabilities and equity from the perspective of economics and law, including comparing any distinction found with the equity theories discussed in accounting literature. While the results of this review of the legal and economics literature cannot be regarded as definitive, because the review was necessarily an overview rather than an in-depth comprehensive analysis, it appears that there is little support from law or economics for the non-compulsion equity theory, despite that theory receiving considerable support in the accounting literature, as was demonstrated in the previous chapter. Therefore, the non-compulsion equity theory seems to be an accounting invention, largely unsupported in the wider legal and economic environment.

This chapter demonstrated that the entity theory appears to have some minor support in the economics literature, but no support from the law literature. The law literature generally,

but not exclusively, appears to support the proprietary theory. However, the proprietary theory did not appear to be supported by the economics literature. The distinction drawn between liabilities and equity in the economics literature appears largely consistent with the residual equity theory. There was also support for this theory in the law literature, where the term "equity" appeared to be more narrowly defined, such that it applied to the lowest ranking shareholders only, the claimants to the residue of the company's assets, consistent with the residual equity theory.

The general lack of support for the non-compulsion equity theory in the law and economics literature contrasts with the considerable support found for this theory in the accounting literature. As noted earlier, accounting does not exist for its own sake but is part of the wider economic and legal environment. Therefore, the support by the accounting literature for the non-compulsion equity theory appears inappropriate.

CHAPTER EIGHT
THE EQUITY THEORY ADOPTED BY THE CONCEPTUAL STATEMENTS

8.1 Introduction

The objective of this chapter is to consider how liabilities are distinguished from equity in the conceptual statements developed by various national accounting bodies, and the International Accounting Standards Committee (IASC), by identifying the underlying equity theory applied in those conceptual statements. To restrict this task to a manageable size, this review will concentrate on the conceptual statements issued by one particular accounting body: the Financial Accounting Standards Board (FASB). As the various national and international conceptual statements contain many similarities, including similar definitions of liabilities and equity, as is shown below, any conclusions reached from a review of the FASB conceptual statements should also apply to these other conceptual statements.

The FASB conceptual statements were selected for review for a number of reasons. Firstly, the FASB was the first accounting body to issue such statements. Therefore, these statements are likely to have had an impact upon the development of the other later conceptual statements. For instance, the various research monographs sponsored by the Australian Accounting Research Foundation while developing the Australian conceptual statements - for example, the monographs on assets (Miller and Islam 1988), liabilities (Kerr 1984) and equity (Kerr 1989) - drew on the work of the FASB and resulted in similar conceptual statements. Secondly, the FASB conceptual statements contain sufficient discussion to enable a meaningful review to be undertaken, unlike, for example, the New Zealand conceptual statement, which is brief. Finally, some of the conceptual

statements issued by the FASB relate specifically to business enterprises, such as the objectives of financial reporting, while non-business enterprises are dealt with in separate statements. In contrast, other accounting bodies, such as those in Australia and New Zealand, have issued conceptual statements that apply to all types of entities. The focus of the FASB on business enterprises is in keeping with the focus of this research, which is also on business enterprises. However, it should be noted that the FASB definitions of financial elements, including liabilities and equity, apply to all types of entities, that is, both business and non-business entities.

The purpose of the conceptual statements is to set out the concepts that underlie the preparation of general purpose financial reports (FASB SFAC1 3). Section 8.2 reviews the objectives of general purpose financial reports, section 8.3 considers the definitions of "liabilities" and "equity", and section 8.4 examines the characteristics of equity discussed in the conceptual statements. Section 8.5 summarises this chapter.

8.2 Objectives of General Purpose Financial Reports

The objectives of financial reporting by business enterprises are detailed in the first FASB conceptual statement. The objectives of financial reporting by non-business enterprises are dealt with in a separate conceptual statement (SFAC4).

General purpose financial reports of business enterprises are intended to provide information about the reporting entity to external users who are unable to obtain special reports that meet their specific information needs (SFAC1 28). This information is intended to assist users in assessing the enterprise's economic resources and claims to those resources, assessing its financial performance and cash flows, and in making decisions about providing resources to the enterprise (SFAC1 40-54).

Potential users of general purpose financial reports include owners, suppliers, lenders, employees, investors, financial analysts and advisors, regulatory agencies, labour unions, employer groups, financial press and reporting agencies, and the public (SFAC1 24). This list of potential users of financial reports is narrowed down somewhat by concentrating on the needs of investors and creditors (SFAC1 30). The conceptual statement focuses on the information needed for investment and credit decisions for pragmatic reasons, to avoid the statement being "vague or highly abstract" (SFAC1 30). The terms "investors" and "creditors" are intended to be used broadly. "Investors" encompasses both equity securityholders and debt securityholders, while "creditors" includes suppliers, customers, employees, lenders and debt securityholders. The conceptual statement notes that debt securityholders are included in both "investors" and "creditors", stating that this is to incorporate the common and legal meanings of the terms "investors" and "'creditors" (SFAC1 35). This focus upon investors and creditors is followed throughout the remainder of the conceptual statement, with frequent references to "investors and creditors", or "investment and credit decisions".

It appears, therefore, that the information needs of owners are considered to be of no more importance than the information needs of other providers of resources, such as creditors. This is demonstrated by the conceptual statement consistently and frequently referring to "investors" - which *includes* debt securityholders - *and* "creditors". There is no emphasis upon owners' information needs. The information needs of non-owners appear to be of as much importance as the information needs of owners. This is consistent with the entity theory (and other theories that extend the entity theory, such as the enterprise theory), where owners are viewed as merely another group that has supplied resources to the entity, of no greater importance than other suppliers of resources, such as creditors (Clark 1993). The conceptual statement's focus on *investors and creditors* contrasts with the proprietary

theory and the non-compulsion equity theory, which focus upon the interests of the *owners*, not debt securityholders or other creditors. The conceptual statement's focus also contrasts with the residual equity theory, which focuses upon the interests of the *residual equity holders*, not all equity holders generally.

8.3 Definitions of Liabilities and Equity

Equity is defined as:

> ...the residual interest in the assets of an entity that remains after deducting its liabilities (49)

Liabilities are defined as:

> ...probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events (35).

These definitions are very similar to those found in other conceptual statements. For example, the New Zealand and Australian conceptual statements, respectively, define equity and liabilities as:

> Equity is the residual interest on the assets of the entity after deduction of its liabilities (ICANZ SOC7.15).
>
> "Equity" is the residual interest in the assets of the entity after deduction of its liabilities (AARF/AASB SAC4 78)
>
> Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events (ICANZ SOC 7.10).
>
> "Liabilities" are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events (AARF/AASB SAC4 48).

It is acknowledged that the FASB, New Zealand and Australian definitions are not identical. However, for the purposes of this discussion, it is possible to summarise them: equity is defined as the residual interest, that is, the interest that remains after deduction of those interests classified as "liabilities"; and "liabilities" are present obligations, which require the entity to transfer resources to other entities. This implies that equity is not an obligation, that is, equity consists of financial interests whereby the entity is *not* presently obligated to transfer resources to those interest holders. This is confirmed:

> ...liabilities...involve *nondisretionary* future sacrifices of assets that must be satisfied on demand, at a specified or determinable date, or on the occurrence of a specified event....distributions to owners are *discretionary*...Generally, an enterprise is *not obligated* to transfer assets to owners except in the event of the enterprise's liquidation unless the enterprise acts formally to distribute assets to owners, for example, by declaring a dividend...(FASB SFAC6 54 and 61, emphasis added).

Equity, in the case of a business enterprise, is stated to be the ownership interest, which stems from ownership rights (60). Equity is increased or decreased by the entity's operations and other events impacting upon the entity. Equity may be also increased through investments by owners and decreased by distributions of assets to owners (51). Contributions by and distributions to owners are non-reciprocal transfers between the entity and its owners (137).

Comparing these definitions of liabilities and equity with the various equity theories, as discussed in chapters five and six, indicates that the definitions are inconsistent with the entity, residual equity and proprietary theories. The entity theory is rejected by defining liabilities and equity as distinct financial elements, despite the objectives of general purpose financial reporting being consistent with the entity theory. Also, equity is not an obligation (SFAC6 54, 61), and transfers between the entity and its owners are considered to be non-reciprocal (SFAC6 137), which is inconsistent with the entity theory, which views all financial interests as obligations, and all transfers to/from financial interest holders, including those with owners, as reciprocal.

Similarly, the residual equity theory is rejected by the view that equity is not an obligation, and the view that transfers between the entity and its owners are non-reciprocal. The residual equity theory considers that all financial interests are obligations, and that all transfers to/from interest holders are reciprocal.

The proprietary theory is also rejected because the *reason* why equity is not an obligation under the proprietary theory differs from that given in the conceptual statements. Equity is not an obligation under the proprietary theory because the entity is not considered to exist separately from the proprietors, so the entity's obligations are to parties other than the proprietors. In contrast, the conceptual statements assert that equity is not an obligation because the entity is not *compelled* to transfer resources to owners unless the entity acts formally to do so, such as by declaring a dividend (SFAC6 54, 61). Hence, the proprietary theory's reason why equity is not an obligation differs from that given by the conceptual statements. The inclusion of declared dividends in liabilities is also inconsistent with the proprietary theory, which views liabilities as obligations to parties *other than* the proprietors. Therefore, the proprietary theory would not include declared dividends in liabilities. Finally, the view that equity is the *residual* interest in the assets, that is, that owners are the claimants to the *residue* of the entity's assets that remain after deducting all prior claims to the entity's assets (SFAC6 213), is also inconsistent with the proprietary theory. The proprietary theory views the proprietors (owners) as owners of *all* of the entity's assets, not merely claimants to the *residue.*

While the conceptual statements' definitions of equity and liabilities are inconsistent with the proprietary, residual equity, and entity theories, they are consistent with the non-compulsion equity theory. As was demonstrated in chapter six, the non-compulsion equity theory considers that liabilities are those financial interests that compel the entity to

transfer resources to another party - which may include owners in the case of declared dividends - while equity is not an obligation as it does not impose any such compulsion on the entity. Because equity is not an obligation, transactions with owners are therefore non-reciprocal. This distinction between liabilities and equity - compulsion versus non-compulsion to transfer resources - is the same as that followed by the conceptual statements. For example, it is noted that liabilities require *non-discretionary* transfers, while distributions to owners are *discretionary*, because the enterprise is *not obligated* to transfer resources to owners, *unless* it acts formally to do so, such as by declaring a dividend (SFAC6 54, 61). Transactions with owners are stated to be non-reciprocal (SFAC6 137) which is also consistent with the non-compulsion equity theory.

8.4 Characteristics of Equity

While the definitions of liabilities and equity follow the non-compulsion equity theory, some of the discussion of the characteristics of equity appear to follow the residual equity theory:

> A major distinguishing characteristic of the equity of a business enterprise is that it may be increased through investments of assets by owners...Owners benefit if the enterprise is profitable but bear the risk if it may be unprofitable...the distinguishing characteristic of equity is that it inevitably is affected by the enterprise's operations and other events and circumstances affecting the enterprise... (SFAC6 51 and 63)

If a financial interest is fixed it cannot be, for example, "affected by the enterprise's operations", other than enabling the agreed rate of return to be paid and the funds contributed to be repaid, but this also applies to financing arrangements that are clearly liabilities, such as bank loans. Fixed interests, therefore, appear to be excluded from equity, consistent with the residual equity theory. For example, non-participating non-redeemable preference shares would be classified as *liabilities* under the residual equity

theory and according to the characteristics of equity quoted above, because the shares represent a fixed interest, and therefore will not "benefit if the enterprise is profitable".

This contrasts with the non-compulsion equity theory, upon which the SFAC6 definitions of liabilities and equity appear to be based. Under the non-compulsion equity theory, equity consists of those financial interests whereby the entity is not compelled to transfer resources to the holders of such financial interests. For example, non-participating non-redeemable preference shares are likely to be classified as *equity* under the non-compulsion equity theory, and the SFAC6 definitions, because the entity is not compelled to transfer resources to the preference shareholders prior to declaring a dividend, except in the event of the entity's liquidation (61).

It appears, therefore, that there is an inconsistency between the conceptual statements' definitions of equity and liabilities, which follow the non-compulsion equity theory, as demonstrated in the previous section, and some of the discussion of the characteristics of equity, which seems more consistent with the residual equity theory.

8.5 Summary and Conclusion

The conceptual statements' definitions of liabilities and equity follow the non-compulsion equity theory. However, the objectives of general purpose financial reporting follow the entity theory, while some of the discussion of the characteristics of equity is consistent with the residual equity theory. The conceptual statements are therefore inconsistent in that they apply several equity theories.

The impact of these inconsistencies may be significant. It has been said that no agreement on many accounting issues is possible until such time as the basic question of which equity

theory should be adopted has been decided upon (Gynther 1967, Bird et al. 1974). Given that one of the stated purposes of the conceptual statements is to assist with the development and review of financial reporting standards (SFAC1 3), the inconsistencies in the approach adopted by the conceptual statements may have a significant impact upon financial reporting standards.

Even if the inconsistencies within the conceptual statements were eliminated, such that, for example, the non-compulsion equity theory was the only equity theory applied, there still remains the question of whether the non-compulsion equity theory is the appropriate basis for the definitions of liabilities and equity. The previous chapter demonstrated that this theory has little, if any, support from law and economics. It seems, therefore, that a closer examination of the non-compulsion equity theory is required. This is addressed in the following chapter.

CHAPTER NINE
NON-COMPULSION EQUITY THEORY

9.1 Introduction

The previous chapter demonstrated that the accounting conceptual statements' definitions of liabilities and equity follow the non-compulsion equity theory. Earlier chapters demonstrated that this theory has received almost no attention as an equity theory in the accounting literature, yet it seems to have considerable support from that literature. However, the theory appears to have little, if any, support in the wider legal and economic environment in which financial reporting takes place. Therefore, the non-compulsion equity theory requires closer examination. This chapter examines various aspects of the non-compulsion equity theory, particularly its adoption by the conceptual statements' definitions of liabilities and equity.

The main features of the non-compulsion equity theory, as established in chapter six, are:

- The entity is viewed as existing in its own right, separate from the owners;
- The financial reporting focus is the owners;
- "Liabilities" consist of obligations that compel the entity to transfer resources to other parties, including the owners, where they have a legally enforceable claim, such as declared dividends;
- "Equity" is not an obligation of the entity, because transfers to owners are discretionary. The entity is not compelled to transfer resources to owners prior to some formal act, such as the declaration of a dividend, except in the event of the entity winding up;
- "Equity" is viewed as the owners' interest, either the *residual* interest - that is, the interest in the *residue* of the assets that remain after deduction of "liabilities" as

determined above - or the *net* interest - that is, the owners' *gross* interest in *all* of the assets *less* 'liabilities" as determined above;

- Transfers to/from owners are viewed as non-reciprocal. For example, contributions by owners do not increase the entity's obligations - because equity is not considered to be an obligation - nor does the entity give up any resources. Consequently, the entity gives nothing in exchange for the contributions by owners. Similarly, it receives nothing in exchange when it makes a distribution to owners;
- Returns payable on investments are treated as expenses to be included in the calculation of net income if the returns relate to "liabilities", and as a distribution of net income if the returns relate to "equity".

One of the features noted above is the view of equity as the owners' interest. This owners' interest is viewed differently by some authors who followed the non-compulsion equity theory. Some authors considered that equity is the owners' *residual* interest - that is, the interest in the *residue* of the assets that remain after deduction of "liabilities" (Sprouse and Moonitz 1962, Kerr 1989), while others viewed equity as the owners' *net* interest - that is, the owners' gross interest in *all* of the assets less "liabilities" (Hatfield 1909, Canning 1929). The conceptual statements define equity as the *residual* interest (FASB SFAC6, ICANZ SOC, AARF/AASB SAC4). Therefore, for the purposes of this chapter's discussion, the non-compulsion equity theory's view of equity as the owners' *residual* interest will be adopted.

This chapter is divided into three main sections. Section 9.2 examines the non-compulsion equity theory's view that equity is not an obligation because transfers to owners are discretionary. Section 9.3 questions whether equity represents the owners' interest, as is assumed by the conceptual statements, and various accounting authors who followed the non-compulsion equity theory, such as Hatfield (1909), Sprouse and Moonitz (1962), and

Kerr (1989). Section 9.4 considers the role of economic substance and legal form for the purposes of classifying particular financial interests, and whether substance or form may be reconciled with the non-compulsion equity theory. Section 9.5 summarises this chapter.

9.2 Equity is Not an Obligation because Transfers to Owners are Discretionary

This section examines and challenges the non-compulsion equity theory's view that equity is not an obligation because transfers to owners are discretionary. Section 9.2.1 considers who exercises the discretion to decide whether transfers to owners are made, and whether the conceptual statements are consistent in their reasoning about this. Section 9.2.2 considers whether transfers to owners are indeed discretionary, or whether an obligation to transfer resources to owners does exist.

9.2.1 Transfers to Owners are Discretionary - At Whose Discretion?

An essential characteristic of a liability is that the *entity* has little or no discretion to avoid making a future sacrifice (FASB SFAC6 36). Therefore, when considering whether or not a particular financial interest is a liability, the essential factor is whether the *entity* has any discretion to avoid making a future sacrifice to the interest holder. To be consistent, if equity is not an obligation, then it follows that *entity* must have the discretion to avoid making distributions to equity interest holders. Yet the conceptual statements assert that equity is not an obligation because distributions to owners are made at the "discretion and volition" of the *owners* or their representatives (FASB SFAC6 54, 61). It seems, therefore, that in discussing whether there is a discretion, the conceptual statements change their perspective from the entity, in the case of liabilities, to the owners, in the case of equity. Authors who adopted the non-compulsion equity theory made similar changes in

perspective when justifying why owners' equity is not an obligation. For example, Sprouse and Moonitz (1962) stated:

> The owners' equity does not constitute an obligation because, ordinarily, the business enterprise is not legally or equitably compelled to provide payments or services to owners other than by the *decision of the owners* or their representatives (38, emphasis added).

The justification for why the owners' equity is not an obligation is based upon the owners' perspective, yet, to be consistent with the discussion of liabilities, the justification should be from the entity's perspective. If transfers to owners are indeed at the owners' discretion, rather than at the entity's discretion, this suggests that if the owners exercise their discretion to decide that a transfer of resources to them should be made, the entity does *not* have the discretion to avoid sacrificing resources to owners. But this means that transfers to owners would be non-discretionary from the entity's perspective; hence these transfers would have the stated essential characteristic of a *liability* - they would be non-discretionary.

Alternatively, one might note that if equity is not an obligation because the entity is not compelled to transfer resources to owners, other than at the *owners'* discretion, this implies that equity consists of financial interests whereby transfers of resources are at the *interest holders'* discretion. That is, if the entity is not compelled to transfer resources to the interest holder, other than at the discretion of the *interest holder*, then that financial interest should be included in equity, if one applies the reasoning of the non-compulsion equity theory. An on-demand loan with no set repayment terms appears to fit this criteria.

Some sense could be made of the applying the owners' perspective to equity if the *owners'* discretion and the *entity's* discretion were one and the same. That is, if the entity does not exist separately from the owners, then any transfers that are at the owners' discretion would also be at the entity's discretion. However, this is not consistent with another feature

of the non-compulsion equity theory - the view that the entity exists separately from the owners.

Therefore, the view that transfers to owners are discretionary because they are at the owners' discretion is based upon inconsistent reasoning. For consistency with the discussion of liabilities, if equity is not an obligation because transfers to owners are discretionary, these transfers must be at the entity's discretion. Section 9.2.2 considers whether the entity does indeed possess such discretion.

9.2.2 Are Transfers to Owners Discretionary?

The non-compulsion equity theory considers that equity is not obligation because transfers to owners are discretionary. The previous section demonstrated that the justification given for this view is inconsistent, because it is based upon the owners' discretion rather than the entity's discretion. However, the question still remains: are transfers to owners discretionary, that is, made at the entity's discretion? For example, does an entity, such as a company, have any obligation to transfer resources to owners, prior to the declaration of dividends?

Company shares may be compared with perpetual bonds. Both shares (unless redeemable) and perpetual bonds have no maturity date. Therefore, the holder does not expect the funds originally paid to the company for the bond or share to be repaid by the company while the company continues as a going concern. The FASB (1990) argued that, although they do not have a maturity date, perpetual bonds are a liability, because they impose an obligation to make future interest payments. Therefore, the *return payable* on the investment, rather than the investment itself, constitutes the liability in the case of perpetual bonds.

So far, when discussing financial interests as liabilities or equity, the discussion has focused upon the whether there is an obligation to repay the investment itself, rather than whether there is an obligation to pay any returns on that investment. However, the conceptual statements make no distinction between transfers to interest holders that are returns *on* investments and transfers that are returns *of* their investments. The essential factor is whether transfers of resources are discretionary or non-discretionary. Therefore, when comparing bonds to shares, for example, the question requiring consideration is whether the entity has any obligation to transfer resources to shareholders, in the same manner as it has an obligation to transfer resources to bondholders.

Shareholders, particularly in the case of publicly listed companies, often buy shares primarily to receive a return on their investment, that is, dividends (Davidson et al. 1984). In effect, such shareholders buy a future income stream, in the same manner as the purchaser of a perpetual bond. With perpetual bonds there is a legal contract specifying the dates and amounts of interest payments to be made to the bondholder, while there may or may not be any such contract for shareholders.

Some shareholders, fixed-rate cumulative preference shareholders for example, do have a legal contract that stipulates the amount of dividends to be paid. While the company may have some discretion as to *when* these dividends are paid - for example, the company may decide to not make a dividend in a particular year due to a lack of funds - the company is still obliged to pay the dividends at some point in the future. In other words, the company's discretion is limited to when, not if, the dividends will be made. There is clearly an obligation to pay a return on these shareholders' investment, in the same manner as there is an obligation to pay a return on perpetual bonds.

While preference shareholders may have a legal contract stipulating the dividends to be paid, ordinary shareholders do not. The question requiring consideration, therefore, is whether the shareholders' expectations of future dividends impose an obligation on the entity. A brief look at some case law suggests they may.

Company case law in New Zealand indicates that there may be an obligation to pay dividends if circumstances permit, even though no dividend has been declared. In the case of Re Waitikiri Links Limited (1989), the company reversed its policy of paying dividends to members and instead used its profits to maintain its golf courses. A minority shareholder, who was also a director, objected to this change in the dividend policy, but was always outvoted. He brought an action claiming minority oppression. It was held that the shareholders were entitled to expect to receive dividends to the extent that the circumstances reasonably permitted. This suggests that the entity may be obliged to pay dividends, even where no dividend has been declared. Furthermore, a company may be economically compelled to meet shareholders' dividend expectations in order to ensure on-going shareholder support, for example, if the company is considering a further share issue (Berle and Means 1932).

The above discussion indicates that the assumption of the non-compulsion equity theory, that the entity is not compelled/obliged to transfer resources to owners prior to some formal act, such as the declaration of a dividend, is questionable. The terms of the share issue in the case of preference shareholders, and shareholders' dividend expectations in the case of ordinary shareholders, may place a legal and/or economic obligation on the entity to pay dividends to shareholders, even though no dividend has been declared.

This conclusion is further supported when one considers that the non-compulsion equity theory, and the conceptual statements, consider transactions with owners to be non-

reciprocal (FASB SFAC6 137). Contributions by and distributions to owners result in the entity receiving or giving up resources without giving up or receiving resources in exchange. If distributions, such as dividends to shareholders, are viewed as non-reciprocal, meaning that the entity gives up resources but receives nothing in exchange, *why* does the entity pay any dividends? Unlike the payment of taxes, which are also viewed as non-reciprocal transactions (FASB SFAC6 137), the entity is supposedly not *obliged* to transfer resources to shareholders (FASB SFAC6 54). It cannot be in the entity's interests to sacrifice resources without receiving anything in exchange, so why does it do so? Reason implies that the payments of dividends results from a perceived obligation to shareholders.

9.3 Equity as the Owners' Interest

The non-compulsion equity theory views equity, in the case of business entities, as the owners' interest (FASB SFAC6 60). Despite this view, this theory classifies financial interests as liabilities or equity according to whether or not the entity is obliged to transfer resources to the interest holders. This makes it questionable whether the reported equity indeed represents the owners' interest.

The conceptual statements do not define the term "owners", despite the frequent use of the term and its apparent importance to the nature of equity. For example:

> In a business enterprise, the equity is the ownership interest. It stems from ownership rights...and involves a relation between an enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role (FASB SFAC6 60, emphasis in original).

This implies that equity represents owners' interests, while liabilities represent non-owners' interests. However, the non-compulsion equity theory, and the conceptual statements,

distinguish between liabilities and equity on the basis that liabilities compel the entity to transfer resources to other parties, while equity supposedly imposes no such compulsion on the entity. This distinction makes no reference to the *identity* of the interest holder, that is, no consideration is given to whether a particular interest holder is an "owner". Instead, the determining factor is the existence, or non-existence, of a compulsion to transfer resources to the interest holder, irrespective of the interest holder's identity. This is confirmed by the conceptual statements:

> Distinctions between liabilities and equity generally depend on the nature of the claim rather than the identity of the claimant (FASB SFAC6 footnote 31).

It appears, therefore, that the distinction between liabilities and equity does not depend upon whether or not a particular interest holder is an "owner", yet it is still assumed that the resulting reported equity represents the owners' interests.

Generally, the term "owners" is applied to those who bear the most risk in terms of both returns on and of their investment, participate in profits and bear its losses, and have control over the entity's assets (Sprague 1907, Paton and Dixon 1958, Kerr 1989, Pope and Puxty 1991). The distinction between liabilities and equity under the non-compulsion equity theory results in equity consisting of those financial interests whereby the entity is not compelled to transfer resources to the interest holders. Profit participation and voting rights, for example, are irrelevant to distinguishing between liabilities and equity under the non-compulsion equity theory, but these features seem to distinguish "owners" from "non-owners". Consequently, although a particular financial interest may not have the features associated with ownership, the financial interest is still classified as equity if it is considered that the entity is not compelled to transfer resources to the interest holder. Hence, the manner in which liabilities and equity are distinguished under the non-compulsion equity theory allows non-owner interests to be included in equity. This means that equity may not represent the ownership interest, contrary to the view of the non-

compulsion equity theory/conceptual statements, indicating an inconsistency within the theory and conceptual statements.

In summary, the non-compulsion equity theory does not distinguish between "owners" and "non-owners" when distinguishing between liabilities and equity, it uses another basis - non-compulsion versus compulsion - but the theory, and the conceptual statements, still assume that the resulting equity represents the "ownership interest", which may not be the case, as shown above.

9.4 Economic Substance, Legal Form and the Non-Compulsion Equity Theory

This section considers the notion of economic substance and legal form for the purposes of classifying particular financial interests.

The current view, as noted in the conceptual statements, is that, if there is any difference between economic substance and legal form, transactions and events should be accounted for according to the economic substance of the transactions/events, rather than their legal form (ICANZ SOC 1993, AASB/AARF SAC3 1990, Kerr 1989). This view is illustrated by the accounting treatment of leasing arrangements. A property lease arrangement may transfer from the lessor to the lessee substantially all of the risks and rewards incidental to ownership of the leased property, although legal ownership may be retained by the lessor. If legal form is depicted, the arrangement is treated as the *rental* of the property, because, legally, ownership *has not* been transferred to the lessee. Accordingly, the property continues to be reported as an asset of the lessor rather than the lessee, and the lease payments are treated as revenue of the lessor and an expense of the lessee. In contrast, if economic substance is depicted, the arrangement is treated as a *sale* of the property from the lessor to the lessee, because, in terms of economic substance, all of the risks and

rewards incidental to ownership *have* passed to the lessee. Consequently, the lessor records a sale of the property and a corresponding debt receivable, while the lessee records a purchase of the property and a debt payable, with the subsequent lease payments treated as debt repayments. Current accounting practice requires depiction of the economic substance of such arrangements rather than their legal form (AASB 1008 1987).

The question of whether economic substance should prevail over legal form impacts upon the classification of financial interests as liabilities or equity. For example, although preference shares are often, in economic terms, more akin to debt than equity, all shares are equity at law (Ross 1994, Schwimmer 1995). Despite the support for the principle of economic substance over legal form, as discussed above, this principle has been criticised as being conceptually elusive, inconsistently applied in accounting practice, and problematic in practical terms (Rutherford 1988, Shearer 1986). It appears, therefore, that the principle of economic substance over legal form is not universally accepted or applied. An example of the inconsistent application of this principle is the ASB's FRS-4: *Capital Instruments*, which requires that all shares, regardless of their economic characteristics, be included in shareholders' funds, because of the legal status of shares (83). Having classified all shares based upon legal form, the standard then requires shares to be analysed as "equity" and "non-equity" interests (40), based upon the fact that some shares are economically similar to debt (83). Hence shareholders' interests are classified and analysed based upon a mixture of legal form and economic substance.

Chapter seven demonstrated that the non-compulsion equity theory's distinction between liabilities and equity does not appear to be supported by *either* economics or law. The legal distinction between liabilities and equity appeared to be based upon the form of the financial interests, with shares classified as equity and other types of interests classified as liabilities. The economic distinction, when a distinction was made, seemed to be based

upon whether interests were fixed or variable. Neither the legal nor the economic distinction, therefore, use the same basis as the non-compulsion equity theory to distinguish between liabilities and equity. The conceptual statements' support for the principle of economic substance over legal form, however, seems to assume that the definitions are consistent with economics. These definitions are supposedly derived from economic phenomena (Stephenson and Chapman 1992). It appears, therefore, that standard-setters believe that the non-compulsion equity theory, including its differentiation between liabilities and equity, is consistent with economic substance. Support for this conclusion is provided by IAS-32: *Financial Instruments: Disclosure and Presentation* (IASC 1995). This standard requires that a particular financial instrument be classified as a liability or equity in accordance with the substance of the arrangement, rather than its legal form (19), and differentiates between liabilities and equity on the basis of whether there is an obligation to deliver resources to another party (20). This differentiation is consistent with the non-compulsion equity theory. However, as noted above, the economists' distinction between liabilities and equity, when a distinction is made, is not based upon whether or not there is a compulsion to transfer resources. Instead, the economists' distinction appears based upon whether financial interests are fixed or variable. This suggests that the accountant's view of the "economic substance" of liabilities and equity is inconsistent with economist's view.

It therefore seems that, although accountants claim that financial interests should be classified according to their economic substance, and seem to think that the conceptual statements' definitions are of economic phenomena, neither the non-compulsion equity theory on which the conceptual statements' definitions are based, nor some recent attempts to set standards for classifying financial interests, appear to be in accordance with economic substance.

9.5 Summary and Conclusion

This chapter examined and challenged various aspects of the non-compulsion equity theory. Section 9.2 questioned the view that equity is not an obligation because transfers to owners are discretionary. It was shown that this view is inconsistent because it is based on the owners' discretion to transfer resources, whereas, to be consistent with the discussion of liabilities, transfers to owners should be at the entity's discretion. It was also shown that, even when viewed from the entity's perspective, transfers to owners may not be discretionary, because the entity may have an obligation to make such transfers.

Section 9.3 observed that the conceptual definitions assume that equity and owners' interests are synonymous. Clearly, under the non-compulsion equity theory they are not. This theory does not differentiate between owners' and non-owners' interests, it differentiates between the compulsion and non-compulsion to transfer resources. Consequently, equity may not represent the owners' interest, because non-owners interests may be included in equity.

This chapter also discussed the issue of whether economic substance or legal form should be depicted when classifying financial interests. It was shown in chapter seven that the non-compulsion equity theory is inconsistent with both the legal and the economic distinction between liabilities and equity. However, there is some suggestion from the conceptual statements and current accounting standards that the non-compulsion equity theory is *thought* to be consistent with economic substance. It therefore appears that the accountant's view of the "economic substance" of liabilities and equity is inconsistent with the economist's view. The conceptual statements' definitions of liabilities and equity are intended to represent economic phenomena, but it appears unlikely that this is so, given that these definitions are not supported by economics.

The combined impact of inconsistent reasoning, questionable assumptions, and the inconsistency with both the economic and legal distinction between liabilities and equity, implies that the non-compulsion equity theory, and the conceptual statements' definitions of liabilities and equity, are fundamentally flawed.

CHAPTER TEN
CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH

10.1 The Conceptual Distinction between Liabilities and Equity

The purpose of this research was to establish the conceptual distinction between liabilities and equity. The accounting conceptual statements contain definitions of liabilities and equity, that are supposedly derived from literature, and are intended to represent "observable economic phenomena" (Stephenson and Chapman 1992, p. 2). One might expect, therefore, that a review of accounting literature, the accounting conceptual statements, and relevant material from the related fields of economics and law, would enable the conceptual distinction between liabilities and equity to be established.

This distinction, however, requires consideration of the underlying equity theory, because there are various equity theories, each of which distinguish differently between liabilities and equity. A lack of consensus between the accounting, law and economics literature, and within the conceptual statements themselves, as to which equity theory should be followed, meant that the conceptual distinction between liabilities and equity could not be established.

10.2 Flaws in the Conceptual Statements and Their Definitions of Liabilities and Equity

The conceptual statements are inconsistent within themselves, as several different equity theories are applied. For example, the nature of equity is discussed in a manner consistent with the residual equity theory, the objectives of general purpose financial reporting appear to follow the entity theory, while the definitions of liabilities and equity follow the

non-compulsion equity theory. These inconsistencies imply that conceptual statements cannot provide the coherent base that they are intended to provide for financial reporting.

Furthermore, the non-compulsion equity theory, upon which the conceptual statements' definition of liabilities and equity are based, was found to be largely inconsistent with any legal or economic view of liabilities and equity. It is doubtful therefore, that the definitions in the conceptual statements do indeed represent economic phenomena.

Finally, the non-compulsion equity theory itself was found to be based upon inconsistent reasoning and questionable assumptions, including its view that equity is not an obligation because transfers to owners are discretionary, that equity represents the ownership interest, and that its distinction between liabilities and equity accords with the economic substance of financial interests.

In summary, the conceptual statements' definitions of liabilities and equity are inconsistent with other parts of the conceptual statements, are inconsistent with economics and law, and are based upon a flawed equity theory. This suggests that a single equity theory should be adopted in the conceptual statements, and that the equity theory should not be the non-compulsion equity theory. This in turn would result in a change to another equity theory.

10.3 An Alternative Equity Theory

Having rejected the non-compulsion equity theory, the other equity theories require consideration.

10.3.1 The Proprietary Theory

The proprietary theory appears to have considerable support from law, but appears unsupported by economics. If the definitions of liabilities and equity are to represent economic phenomena, this suggests that the proprietary theory is not an appropriate basis for these definitions. Also, while this research focused upon business entities, the definitions in the conceptual statements are intended to apply to all types of entities, not just business entities, and the applicability of the proprietary theory to non-business entities has been questioned (Staubus 1959). Even in the case of business entities, the applicability of the proprietary theory to companies has been questioned (Paton 1922). Overall, therefore, the proprietary theory does not appear to be a viable option.

10.3.2 The Entity Theory

The entity theory draws no conceptual distinction between liabilities and equity, which is contrary to other evidence presented in this thesis that indicates that there is a distinction, which is of some considerable importance. Clark (1993), for example, conducted a comprehensive review of the economics literature and concluded that there is, or should be, a distinction between liabilities and equity. This suggests that the entity theory is also not a viable alternative.

10.3.3 The Residual Equity Theory

Unlike the entity and proprietary theories, the residual equity theory does appear to present a viable option. Firstly, considerable support for it was found in both the law and economics literature, although admittedly further research would be required to confirm this conclusion, as the material presented in this thesis was necessarily an overview, rather

than an in-depth analysis. However, the apparent support from both law and economics differentiates the residual equity theory from the entity, proprietary and non-compulsion equity theories, each of which seem unsupported by either law, or economics, or both.

Secondly, the residual equity theory seems to accord with the accountants' concept of equity. This is indicated by the discussion of the characteristics of equity discussed in the accounting conceptual statements, which accords with the residual equity theory. Some accounting authors supported the residual equity theory, including Paton and Dixon (1958), and Chambers (1966), and there were some authors who followed the non-compulsion equity theory, Kerr (1989) and Sprouse and Moonitz (1962), but who discussed equity in a manner consistent with the residual equity theory.

Thirdly, the residual equity theory appears to accord with the view that equity, in the case of business entities, represents the owners' interests. Some of the features associated with ownership - that owners bear the most risk in terms of returns on and of their investment, and that owners participate in the entity's profits and bear its losses - accords with the residual equity theory's view of equity as the residual variable interest.

Finally, the residual equity theory views all financial interests as obligations, and therefore all transactions with interest holders as reciprocal. Hence it avoids some of the deficiencies of the non-compulsion equity theory, such as that theory's questionable assumption that equity is not an obligation because transfers to owners are discretionary, and that theory's failure to explain why transfers to owners occur if they are non-reciprocal transactions, given that it cannot be in the entity's interests to transfer resources if nothing is received in return.

Overall, therefore, the residual equity theory appears to be the best option to replace the non-compulsion equity theory as the basis for distinguishing between liabilities and equity.

10.4 The Distinction between Liabilities and Equity: Problem Solved?

This research established that the conceptual distinction between liabilities and equity requires consideration of the underlying equity theory, and that the residual equity theory appears to be the most appropriate basis for distinguishing between liabilities and equity. This suggests that if the residual equity theory is consistently adopted by the conceptual statements, the deficiencies of the present definitions of liabilities and equity will be eliminated. Whether this will resolve all problems relating to liabilities and equity, and the distinction between them, requires further research to examine the practical implications of adopting the residual equity theory. For example, two questions requiring consideration are: firstly, would it be possible to readily identify the residual equity holders? And, secondly, would the present problem of classifying hybrid financial instruments be resolved?

To answer this first question, it would be necessary to consider whether there is only one group that constitutes the residual equity holders - the "absolute residual" - or whether there are layers of residual equity holders (FASB 1990). For example, consider two types of financial interests that bear losses and profits equally while the entity continues as a going concern, collectively rank below all other interest holders, and have equal rights to the surplus assets upon winding up. These two types of financial interests both appear to be variable and residual, that is, "equity" under the residual equity theory. However, if, upon winding up, there are insufficient assets to repay the investment of both types of interest holders, and in this case one interest is preferred over the other, does this mean

that only one type of financial interest is the residual equity holder? If the entity is expected to continue as a going concern for the foreseeable future, are rights upon winding up relevant to distinguishing between various financial interests? These are examples of the issues requiring further consideration if the residual equity theory is to be considered.

The second question raised above is whether the adoption of the residual equity theory would resolve the present problem of classifying hybrid financial interests. In other words, if a consistent and coherent *conceptual* distinction between liabilities and equity is established, would this mean that, *in practice*, all financial interests could be readily classified as either liabilities or equity, and thus creative accounting eliminated, at least in this respect? Clearly, future research is required to examine the practical implications of classifying particular types of financial interests under the residual equity theory. However, if adequate definitions of liabilities and equity are a starting point (FASB 1990 SFAC6), this suggests that establishing a consistent and coherent conceptual distinction between liabilities and equity would, at least, go some way towards eliminating classification problems, and would thus be an improvement on the present situation.

ACKNOWLEDGEMENTS

First and foremost I wish to thank my thesis supervisor, Sue Newberry, for all of her guidance, encouragement, and invaluable comments on earlier drafts of this thesis. I also wish to thank David Cope and Julie Horward for their helpful comments. I am grateful for the support and understanding of my family and friends, particularly my husband Barry, while working on this thesis and throughout my Master of Commerce studies.

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