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The Proprietary Theory and the Entity Theory of Corporate Enterprise.

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THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

A Dissertation

Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
in partial fulfillment of the
requirements for the degree of
Doctor of Philosophy

in

The Department of Accounting

by

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B. S. B. A., Boston College, 1950
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ABSTRACT

Today there are two theories attempting to explain ownership of the corporation, the proprietary theory and the entity theory. There are numerous conflicting ideas about the meanings of these theories. This dissertation attempts to determine what is meant by each of these.

The problem was approached by studying the proprietary theory and the entity theory of corporate enterprise as presented by writers in fields of law, taxes, investments, management, economics, and accounting, and by analyzing the position of stockholders, creditors, managers, employees, and government under the proprietary and entity theories of corporations.

Two theories pertaining to the granting of authority to the corporation are recognized in law. The association theorists hold that the stockholders associated together transfer to the corporation the rights necessary to carry on the business. This is a proprietary theory approach to corporate theory. The fiction theorists state that the state gives the necessary authority to the corporation as an impersonal being to carry on business activity. In so doing the state does not recognize what already exists, as proprietary theorists hold, but, following the entity theory, the state creates a new being separate and distinct from its...
In the field of taxation, one finds a common dispute among authors. The proprietary theorists claim there is a double tax on corporate and stockholders' income because both stockholders and corporations are taxed on the same income. The entity theorists claim there is no double tax because the income tax is levied on the corporation as a separate and distinct being from the stockholders and other interested parties.

In investments some authors speak of stockholders as merely investors and not as owners of the corporation. When the stockholders take a passive attitude and do not participate in corporate matters, following the entity theory, they act like creditors. Although the stockholder may not exercise his rights in the corporation, this is no reason for saying the rights do not exist or that he is not the owner of the corporation, according to the proprietary theory.

Management plays an important role in the corporate enterprise. Although management performs the function of managing corporate affairs, with authority delegated by the stockholders, some consider management as an entity in itself rather than an employee of the stockholders. The part owners previously played in the corporation has been taken over by
management. Therefore, the divorce of ownership and control seems to indicate the entity theory or a managerial approach to corporate enterprise theory.

Economists usually take a broad view of the corporate enterprise because they consider the corporation in relation to the whole economy. Some economists hold that there is little difference between the interested parties (stockholders and creditors). In so doing they seem to follow an entity approach. However, there are other economists who follow the proprietary theory because they make a marked distinction between the stockholders and creditors.

The accountant must decide whether to follow a proprietary approach or an entity approach when accounting for corporate transactions. The proprietary theory is a stockholders' approach and the formula \( A - L = C \) is appropriate because it demonstrates the stockholders as the residual claimants. The entity theory is a managerial approach and the formula \( A = (L + C) \) is appropriate because it demonstrates the oneness of the unit and shows the obligations to all claimants together.

There are many conflicting ideas among authors in various fields regarding the proprietary and entity theories. A great deal of benefit could be gained if a more uniform approach to the ownership problem of the corporation was
followed by theorists in law, taxes, investments, management, economics, and accounting.
CHAPTER I

INTRODUCTION

There exist in accounting two theories pertaining to ownership of the corporation enterprise. One is called the entity theory and the other is called the proprietary theory. The studies made of these two theories in the past started with the corporate enterprise but the results differed considerably from each other.

Problem. The problem of this dissertation is to make valid comparisons of the existing material about the corporate enterprise to see what is meant by the entity theory and by the proprietary theory of corporate enterprise.

Importance. Accounting must operate within a sphere of certain basic assumptions. A basic assumption of paramount importance is whether or not to follow the entity theory or the proprietary theory of corporate enterprise. The accounting procedures followed in handling certain transactions will vary depending upon the assumptions made. Hence, an understanding of the entity theory and the proprietary theory is important.

It is not clear what is meant by either the entity theory or the proprietary theory of corporate enterprise
because of the different ideas presented by numerous well-known authors. Each author establishes his own hypotheses which usually change the whole situation. Hence, his analysis will differ from the studies of the other authors and special care must be taken when comparing their works.

**Scope.** In order to present a study of the corporate entity theories it is important to analyze the literature pertaining to such theories. Therefore, the problem is approached by studying the entity theory and the proprietary theory of corporate enterprise as expressed by authors in the areas of law, taxes, investments, management, economics, and accounting.

**Method.** Each of the first seven chapters is planned to give the reader the different concepts of a specific area of thought pertaining to the entity and proprietary theories with specific reference to the stockholder, the creditor, the manager, the employee, and the government. No conclusions are attempted in these chapters because the purpose is not to determine the legal, tax, accounting, economic, management entity or proprietary theory of corporate enterprise but the purpose is to combine all the sources presented into a uniform idea of entity and proprietary theories of corporate enterprise. The various ideas are analyzed and combined in the final chapters of this dissertation.
History. The entity theory is often developed in accounting literature by referring to the time of the Roman Empire where there were slaves acting in business ventures for their masters. A master would give his slave a certain amount of money or goods which the slave was to invest wisely. When profits were made, the gains were turned over to the master. The slave was owned by the master and all that the slave possessed belonged to the master but the slave carried on the business of the enterprise as a separate party. Such an example can illustrate the entity or proprietary theory depending on how it is used. If the slave is considered as a person independent of his master's actions, the entity theory of enterprise results. By definition, however, a slave has no right to own property in his own name, and hence, the illustration is more suitable to the proprietary theory because the property ownership was in the hands of the slave owner, with the slave being merely an appendage of the owner.

The idea of the corporate entity as it is used today began in the seventeenth century.

It is generally agreed that the corporate concept as we understand it today was first promulgated by Lord Coke about 1600; and his declaration that the corporation is an entity, an artificial person created by the sovereign, found expression by Chief Justice John Marshall in the famous Dartmouth College case (Dartmouth College v. Woodward, 4 Wheat. (U.S.) 518 (1819)). There is still, however, controversy whether the corporation is an entity created by the law or whether it is merely a group of persons bound
together by a contractual relationship.¹

Thus, in the seventeenth century, the double meaning of the corporate enterprise was introduced—the entity as such and the proprietary concept.

The forms of business organization which were found in England during the eighteenth century did not help to clarify the entity and proprietary theories because

... business organizations were for the most part simple in structure and personal in nature. Sole proprietorships predominated. For legal and economic purposes the individual owner and his business were identical. Partnerships were also numerous. The need to collect more capital or the need to divide important management tasks among several owner-participants as the scale of business operations increased gave the partnership considerable popularity. Frequently organizations sprang up in the form of unincorporated joint-stock associations.²

Thus, when the new entity doctrine was introduced, it was difficult to comprehend the idea of a separate and distinct entity existing independent of its owners, which this new theory of an impersonal being connotes.

The greatest reason for the corporate form of business organization was for the protection of the investors or stockholders. With the introduction of this new form of business organization, the investors or stockholders were


organization, "... the liability of the stockholder is limited to the possible loss of his investments in the corporation, provided the stock has been fully paid and is non-assessable." The greatest loss that the owner of capital stock in a corporation can suffer is his capital contribution. None of his other personal assets can be attached as they might be in the other forms of business enterprise.

The union of investors into a corporate enterprise for the express purpose of carrying on business activities usually facilitates the borrowing of capital as well as protecting the other investments of the stockholders. With this new form of business organization, large amounts of wealth can be accumulated and the borrowing of more needed capital is facilitated because the resources of the new business unit are much greater than the usual resources of a sole proprietor or a partnership.

The corporation offered the most effective device for combining the separate investments of many individuals under unified business control in a single business entity, while preserving the safety

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4 There are exceptions to this general rule and the exceptions will be considered in a later chapter.
of the wealth of the individual owners not directly invested in the corporation.5

The concept of the corporate entity according to French doctrine is entirely different from the English and American ideas. The entity unit is called a société in France and a description is as follows:

A société (the generic name for all types of profit seeking associations from a partnership up to a true share capital corporation) was constituted by an active contract between the parties, and the parties were considered the stockholders. The entity results only from the segregation of a common enterprise and a common body of property coupled with a common administration. In this aspect the administration of the concern was more nearly a joint agency. Continental law, however, found the entity not in the legal form but in the enterprise; thus although the legal société may be reformed or entirely broken up, as by bankruptcy, the entity may persist where there is a defined enterprise which continues in existence. This realization that an economic unit maintains its existence in large measure irrespective of individuals or of legal machinery for its administration is well known now to economists in England and America, although its legal implications have never been adopted into Anglo-American law.6

Definitions. An interesting comment made by Bowers in an article in The Accounting Review with respect to the terminology used by accountants is as follows: "Accounting and social economics deal with concepts which may be somewhat


alike, but are not much alike. Some use of common terms has tended to confuse important differences. This statement expresses one of the greatest problems found in the research for this dissertation. Some authors define the terms used but others take the definitions for granted. In the latter case, the reader must assume that the author means this or that and at times an incorrect conclusion results.

Because the following definitions are fundamental, they are given to establish a foundation for other definitions which are to follow.

An asset is anything, tangible or intangible, of value owned and title to the good rests in the owner.

A liability is a claim against a person or a business.

Net worth or owner's equity in a corporation represents the total capital stock and surplus.

Investors are personal or impersonal beings who own capital stock or bonds. The terms stockholder and bondholder, however, will be used unless the meaning is obvious.

Stockholder is a person who owns capital stock of a corporation.

Bondholder is a person who owns bonds of a corporation.

Creditors are the possessors of the corporate debt which includes short term creditors (current liabilities) and bondholders.

The government refers to the federal government and when a state government is referred to, it is expressly stated.

Employee refers to the non-management group who are sometimes referred to as the workers or laborers.

Management refers to the managing group of the corporate enterprise. For purposes here, management refers to the board of directors and officers of the corporation.

Enterprise is a business venture organized to make a profit and to provide a service.

Corporate enterprise is an incorporated business organization and is used synonymously with corporation.

Corporation is a chartered business enterprise organized under the laws of a state which gives the corporation its charter.

Formulas. In studying principles, it is sometimes feasible to use mathematical formulas. There are two formulas that are used in accounting to show the relationship of the separate parts of the balance sheet. These formulas are also used to express the interest and claims against the assets of the corporation. Most authors use both formulas
synonymously or in some cases, only one formula is presented. At first glance, both formulas appear to be identical but upon closer examination, there is a decided mathematical difference between the two. The formulas are as follows:

Assets equal Liabilities plus Net Worth.

Assets minus Liabilities equal Net Worth.

If each part were considered separately, there would not be any difference between the formulas according to the principles of algebra. However, according to algebra, if liabilities plus net worth are considered as one complete unit, the transposition that took place in the second formula could not be made. Hence, two separate formulas for two separate concepts.

The formula, assets equal liabilities plus net worth—usually written, \( A = L + C \) (net worth or capital)—presents the entity theory. The corporation has all of the assets and the total interest and claims against the assets are represented by the liabilities and the owner's equity or net worth.

The formula, assets minus liabilities equals net worth—usually written, \( A - L = C \)—presents the proprietary theory of corporate enterprise. The contention here is that the corporation is owned by the stockholders and that their claims are residual in nature. After the obligations of the creditors have been satisfied, the stockholders have that which is left.
Stockholders and taxpayers. In order to understand a situation, it is sometimes appropriate to compare it to something else. The stockholder of a corporation is quite similar to a citizen taxpayer of a country. The taxpayer invests money in the government through his contribution of taxes and it is often said that the taxpayer is the government. The intent is not that the people as such are the government but taken collectively, the people are the government. Since the masses could not hope to operate the government effectively, men are elected and appointed who do the bidding of the people as the board of directors and officers of a corporate enterprise do the bidding of the stockholders. It would be impossible in cases where there are numerous stockholders for each owner to exercise control. The operations of the corporation's business are placed in the hands of a few men who have a fiduciary responsibility to carry on the business of the corporation for the best interest of all parties concerned.
CHAPTER II

LEGAL VIEWPOINT

OF THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

The corporation is an enterprise chartered by the state according to state law. The laws of the state limit the extent of the activities, the rights, and privileges of the corporate enterprise. Thus, the study of the legal aspect of the corporate enterprise is important.

Pegrum presents the following definition of a corporate enterprise.

'Corporation' is really a generic term used to denote that form of business organization which uses the legal device of a separate personality, as distinct from the real owners of the enterprise. . . . It is a single unit operating independently, and although this unit may engage in many different types of business activity, it does so through a single corporate charter.

Since the corporate enterprise is established by law and operates by virtue of a state charter, the only way in which a corporation can be dissolved is by an act of the state government. According to the law, the corporate enterprise which is established by law, the legal

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entity, is not considered abolished "... because of insolvency, a failure to elect officers, a cessation of business, or a sale or disposal of all of the corporate property." The corporate enterprise still exists, if in name only, and can sue or be sued as any other corporate enterprise which is doing business regularly.

Following are some of the comments made by different authors in law with respect to the ownership of the corporate enterprise. As can be seen, the comments vary widely when considering the entity theory, the proprietary theory, the stockholder, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete entity theory and the proprietary theory of corporate enterprise is presented in the eighth chapter.

Two theories. In law there are two distinct theories regarding the granting of power or the recognition of authority in the corporate enterprise. The fiction theory considers the law of the land as the source of authority and the association theory considers the union of personal beings as the authority and the law as purely a regulatory

power. The fiction theory has the government giving the power to act to the corporate enterprise and the association theory states that the rights of the stockholders are transferred from the stockholders to the corporate enterprise. It can be said that the fiction theory is the entity theory and the association theory is the proprietary theory.

**Stockholders.** In small corporations, it is difficult at times to distinguish between the owners of the corporate enterprise and the corporate enterprise itself because the owners are usually the managers. In large corporate enterprises, the distinction is more easily recognized because of the divorce of ownership and management. Because of the size and power of large corporate enterprises, it is said

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3 Pegrum, op. cit., pp. 56-57 and 59. Within these pages, Pegrum describes the fiction theory and the association theory.


"Corporations--Corporate Entity--Dissolution--Disregarding the Corporate Entity in De Facto Dissolution," op. cit., pp. 210-211. Within these pages are found the following two expressions of the fiction theory and the association theory.

1. The state gives the corporate enterprise the power to act.
2. The state recognizes the power to act of the corporate enterprise which already exists by virtue of the corporate stockholders.
that the stockholder is merely an investor\(^4\) and not a true owner. This position would derive its foundation in the fiction theory because the authority and power of the corporate enterprise arises from the state and no transfer of authority from individuals is necessary as is the case with the association theory.

The fiction theory holds that the law of the land is the important factor in corporate enterprise theory because the law gives birth to the corporate enterprise. Some ideas are presented here which serve to bolster the fiction theory.

The possession of capital stock by a stockholder does not represent ownership but it is evidence of a right.\(^5\) The right or bundle of rights of the stockholder in the corporate enterprise entitles the stockholder to share in the profits of the corporation when dividends are declared, to attend stockholders' meetings, to vote on corporate enterprise policies and business, to share in the management of the corporate enterprise, and many other privileges which may accrue to the stockholder because of the corporate charter and bylaws.

When it is impossible to distinguish between the

\(^4\) The term investor is being used here in the sense of an inferior creditor rather than a stockholder.

business of the stockholder and that of the corporate enterprise or the business of the parent corporation and the subsidiary corporation, no corporate entity exists but the combination is just one enterprise. The identity theory which identifies the two corporate enterprises as one, would be invoked. Even though the two corporate enterprises operate as separate units, they would be considered as one entity by the law.

The law is very specific when it says that the corporate entity is a separate and distinct creature. This is exemplified by the fact that a stockholder can sue a corporation in which he owns stock or the stockholder can be sued by the corporate enterprise in which he has invested. Legally, the two persons, the stockholder and the corporate enterprise, are separate in the eyes of the law.

If the stockholder owes the corporate enterprise money, the stockholder is liable for the payment of the debt to the corporation and it must be paid to the corporate enterprise, especially, if the creditors sue. Here again,

the law is very specific in the division between the corporation and the stockholders of the corporate enterprise.

There are cases where there are several classes of common stock and some of the classes of common stock do not have voting rights attached. Thus, the nonvoting common stockholder has limited rights in the corporate enterprise and in a sense, his position is weaker than the bondholder. This stockholder does not possess the right to elect directors which means he has no voice in the management of the corporate enterprise. Hence, he is just an investor and similar to the bondholder with the exception that the bondholder receives a fixed return each year and the nonvoting common stockholder depends on the directors to declare a dividend in order to receive a return on his investment.

Pegrum brings out the idea that the corporate enterprise occupies an important position in American business life. He continues to say that the corporate enterprise is a true form of business organization and "... not a method of doing business."9 The corporate form of organization has been "... selected for purposes of convenience without altering the structure of the particular enterprise and without presenting any unique questions of public

9 Pegrum, op. cit., p. 67.
This attitude is in contradiction to other authors who claim that the corporate enterprise is just a method of doing business.

If all of a corporation's capital stock is owned by one person, Anderson\textsuperscript{11} states, the courts have held that the entity does exist when there is evidence of separation of ownership and control. However, Anderson\textsuperscript{12} further points out that in cases where there is ownership of a corporate enterprise by one person and this one individual exercises control, the courts have decided against the corporate enterprise and the enterprise is treated as a sole proprietorship.

A corporate enterprise has far reaching authority in the distribution of its wealth. In making donations to institutions of learning as the Princeton University case shows, the minority stockholders sued the corporate enterprise but the court . . . reviewed the various decisions and articles which have justified such donations on the basis of the direct benefits available to the corporation by way of assisting in providing a reservoir of

\textsuperscript{10} Ibid., p. 68.


\textsuperscript{12} Ibid., pp. 23-24.
trained personnel and creating goodwill and friendly public relations for the corporation.\textsuperscript{13}

Since the corporate enterprise has grown to such enormous size, both physically and financially, laws have been passed to protect people who deal with the corporate enterprises. Protective laws have been passed restricting the corporate enterprise but not the stockholder.

The emergence of the concept of protection of individuals, be they suppliers or customers, along with the emerging system of rights of labor and workmen, means in substance a system of protection for the individuals constituting all of the groups with which a great corporation comes into contact.\textsuperscript{14}

If it were possible for stockholders to bind the corporate enterprise in any contract, it would be an easy matter to say that the stockholder owned the business organization. However, this is not the case, for only the board of directors or their agents can act to bind the corporate enterprise.\textsuperscript{15}

The association theory holds that the stockholder is an integral part of the corporate enterprise since

\begin{itemize}
\end{itemize}
the organization receives its power and authority from the stockholders. Some of the following comments by different authors are given here to bolster the association theory.

In two specific cases, the stockholder may be held directly liable for the debts of a corporate enterprise.\(^\text{16}\) When the wages of the employees are not paid, the stockholders are liable up to a certain amount—generally wages for three months—and when the double liability clause is in effect, which is found in banking and other restricted forms of business, the stockholders are liable to an amount equal to their capital contribution if no surplus provision has been made.

Stevens says that, "One is brought to the conclusion that corporateness is more nearly a method than a thing."\(^\text{17}\) This corporate form is used to the advantage of the stockholders and represents only a method of organization rather than a completely new form of business organization completely distinct from its stockholders.

When the court says that the stockholders are liable for the acts of the corporate enterprise, it does not mean that the entity's responsibility is that of the stockholders. But, the court is saying that the entity does not exist in

\(^\text{16}\) Lavine and Mandel, op. cit., p. 432.

\(^\text{17}\) Stevens, op. cit., p. 91.
this case and hence, the stockholders are treated as partners and the stockholders are personally responsible for the acts of the so-called corporate enterprise.\textsuperscript{18}

Even though the stockholders cannot override a director when he is acting within his authority, the stockholders may increase the number of directors or remove a director if the bylaws permit such action.\textsuperscript{19} The usual case is that a new group of stockholders will win control of the necessary votes and this new group, as a solid voting block, will determine the new directorate. Although the stockholders do not directly control the corporate enterprise, the stockholders can vote in a directorate which will be more favorable to them. By so doing, the new directorate usually bows to the dictates of the stockholders holding the majority of votes.

In Texas, there was a case which permitted the stockholders of a corporate enterprise to examine not only the books of the corporation but also the books of its subsidiary because the board of directors of the subsidiary company were working indirectly for the stockholders of the parent corporate enterprise.\textsuperscript{20} Such a decision would follow the association

\textsuperscript{18} Powell, \textit{op. cit.}, pp. 1-2.
\textsuperscript{19} Stevens, \textit{op. cit.}, pp. 549-550.
\textsuperscript{20} \textit{Ibid.}, p. 85.
theory since the stockholder is the authority behind the corporation. Usually, however, the activity of the parent is the responsibility of the board of directors and it would be the board of directors who would inspect the books of the subsidiary.

Israel points out that when there are two corporate enterprises doing business with one another and both corporate enterprises are owned by the same stockholders, these same stockholders may be prevented from claiming separate entities in the eyes of the law, in order to protect third parties. Hence, the owners cannot set up two separate corporate enterprises because the law will deem both organizations as a single corporate enterprise or entity. It is possible, however, to have two separate corporate enterprises owned by the same stockholders and considered legal, as was previously pointed out.

Creditors. The creditors of a corporate enterprise, according to law, have no positive position in a corporation until there is a default in the payment of debts. The relation of the creditors to the corporate enterprise is a debtor-creditor relationship. The creditors must make their

claims against the corporate enterprise except in a few restricted cases which are brought out in this chapter.

Under certain conditions, bondholders have been given the right to vote in a corporate enterprise. This usually occurs when the corporate enterprise is in financial difficulties and the company fails to meet the obligation of interest payments to the bondholders. Most bond indentures stipulate that the trustees of the bondholders will have the right to vote until the interest debt is settled in full or until other action is taken.

Since the creditors have loaned money or have extended credit to the corporation, some claim that the creditors possess rights against the assets of the corporate enterprise. In the use of double entry bookkeeping, they hold that this right can be seen for there must be a credit for liability or equity against all of the assets otherwise the debits and credits would not be equal. Spencer brings out the same idea when he says that it can be further stated that the claims of the creditors are against the assets of

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23 Pomeroy, op. cit., p. 50.
a corporate enterprise and not against the stockholders. This is a truism if there is no fraud present and the corporate enterprise is considered a valid entity.

To further the cause of the creditor, the laws for the State of Oregon state that management may work for the benefit of the creditor when the corporate enterprise is in financial difficulty and until the corporate enterprise is out of debt. The laws in the State of Oregon were passed with the intent of protecting the creditor against any irregularities on the part of the stockholders.

When dividends are declared payable, the stockholders become bona fide creditors of the corporate enterprise. In cases of insolvency, the stockholders then share, pro rata, with the other creditors of the corporate enterprise for their rights as creditors.

Stockholders may be creditors of a corporate enterprise in which they possess capital stock and they may carry on business with this corporate enterprise like any other corporate enterprise. This practice is good business, in most cases, as long as no minority stockholder is injured and all the transactions are legitimate.

At times, the subsidiary corporate enterprises have

been denied the right to collect claims they have against the parent corporate enterprise when the parent has become insolvent. The position of the subsidiary corporate enterprise is the same as for all other creditors.

**Government.** The governments of country and state are immune from the suits that must be faced by others. Permission for suing a governing body must be granted by that governing body before the claimant can go to court. However, in cases where the government is the sole owner of the corporate enterprise, the courts have held that the entity theory exists and the claimant is suing the corporate enterprise and not the governing body which does not necessitate the request of permission to sue. Hence, ownership by the government of a corporate enterprise does not give the corporate enterprise immunity but it must be remembered that these government owned corporate enterprises cannot be taxed by other governing bodies. Thus, some inconsistency is present since the reason for no tax is because the corporate enterprise is owned by a governing body.

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26 Stevens, *op. cit.*, pp. 85-86.

27 Although some government businesses take on a corporate form they do not possess sovereign powers as the state and federal government bodies do.

28 Stevens, *op. cit.*, pp. 76-79.
Management. There is little doubt that management plays an extremely important part in the corporate enterprise structure. Since the growth of the corporate enterprises and the division of interest which has taken place in the last century, management has been given the part of directing the activities of the large corporate enterprises. The corporate organizations which were owned and operated by large family interests do not exist today as they did in the past. There are still a few family corporate enterprises but even here, the trend is to give management more and more power.

The authority of professional managers has been increasing because of the efficiency and good management which has been developing. In some of the large corporate enterprises, the officers’ power has become so great that "... the more usual situation is for management to select the directors." It is a right of the stockholder to select and elect the board of directors.

Management has been given a direct interest in some corporate enterprises with the introduction of a new policy for paying their salaries, partly in cash and partly in the capital stock of the corporate enterprise. Another method of salary payments is the paying of a regular salary.

29 Goode, op. cit., p. 21.
plus a percentage of the corporate profits. Actually, the profits of the corporate enterprise belong to the owners of the business but now some claim that the earnings are being divided between the owners and the officers. 30

The direct powers of corporate management vary with the different states and the individual cases within the states. However, management's power has increased tremendously over the years. Following are a few examples of management's strength in the corporate enterprise.

Some cases have held that although preferred stock was noncumulative, if dividends were earned they could not be withheld. However, "... corporate management demanded and got not merely a power to manage business, but also a power to determine the stockholders' property rights." 31

In order to set up the best and most profitable organizations, "... corporation lawyers at the insistence of organizers and corporate managements, have endeavored to give such managements the widest possible scope of power." 32

30 Even though management shares in the profits of a corporate enterprise, they do not share in the losses. The true test for ownership is the sharing of losses and gains. Hence, it can be argued that since management does not share in the losses of a corporate enterprise, their position is not on a par with the stockholders.


32 Ibid., pp. 28-29.
It is not possible for the stockholders of a corporate enterprise to bind the company for it is only management who can bind the corporate enterprise. No matter what contract a stockholder makes in the corporate name, it is not binding unless that stockholder is acting by virtue of authority granted by management.

There are cases where the power of management is much greater than the power of the stockholders and this authority has been given by the corporate charter.

The statute authorizing incorporation, in most instances, permits great latitude in drafting the charter, so that it may include permission to handle the corporate business and to deal with stockholders' rights almost as the management chooses.

The duties of a director in a corporate enterprise some hold are to the corporation he is affiliated with and his responsibility is not to the stockholder. In cases where there is a question as to policy of the corporate enterprise, "The judgment of the directors is in most circumstances controlling."

The right of action against the directors of a

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corporate enterprise belongs to the corporation and/or the
stockholders when the directors are being accused of mis-
management. In the case of bankruptcy action may be brought
by receivers or trustees for the benefit of the creditors
of the corporate enterprise.37

An interesting theory dealing with the powers of the
directors, was that the directors received all of their
powers from the state.38 This theory is not held today.
Since the state gives the corporate enterprise its rights
according to the fiction theory, it is not too unreasonable
to believe that the authority of the directors also derives
from the state. It is a logical conclusion from the fiction
theory.39

A director of a company may carry on separate busi-
ness with the company of which he is a director if permission
is obtained from the disinterested directors or a majority
of the stockholders. However, in cases of insolvency or
when the corporate enterprise is on the verge of insolvency,
the director cannot have a position of preference over the

37 Henry Winthrop Ballantine, Editor, Problems in
38 Stevens, op. cit., p. 547.
39 Even though the state may grant the authority
to the directors it is still the stockholders who permit
the exercising of this authority.
general creditors by having the corporate enterprise liquidate his debt.

In Maryland, Berle relates, the board of directors have the following powers:

1. To sell no par stock at whatever price they deem appropriate.
2. To buy and sell treasury stock.
3. With permission granted in the charter, they can buy treasury stock and cancel it out of capital funds.
4. If the corporate enterprise has unissued capital stock, the directors can reclassify the stock ahead of the outstanding stock and place the stock on the market.

Even though the corporate enterprise is a separate entity, it must act through someone since it is an impersonal being. The board of directors are elected by the stockholders to represent them in all the ventures of the corporate enterprise and hence, the members of the board have a fiduciary responsibility to the owners or stockholders.

In our society, Berle points out that, "... the power of corporate management is becoming practically absolute, while social controls upon their power remain almost embryonic." He also says, "... a man with

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40 Spencer, op. cit., pp. 1072-1073.
42 Ibid., p. 27.
$1,000 to invest places this in the hands of a corporate management, taking in return the obligation of the corporate management to give him some stipulated share of the results of the enterprise."43

Miscellaneous. Because of the need for mass production and the development of industry, corporations have become an integral part of society. Countries have found a need for the establishment of business organizations throughout history and the corporate enterprise form of business organization seems to have solved the problem.

The purpose of the corporate entity and the reason that the laws have given the corporations the limited liability is for a justifiable reason and this privilege should not be misused.44 If a corporate enterprise is used for fraudulent purposes, the courts have held that no entity exists and the guilty parties themselves are liable directly since there is no corporate existence.45 Stevens46 contends that the purpose of incorporation is not to defraud creditors,

43 Berle, loc. cit.
44 Powell, op. cit., p. 2.
45 Conyngton and Berg, op. cit., pp. 269-270.
46 Stevens, op. cit., p. 89. Incorporation costs may be paid for by the corporation if the directors and stockholders so choose.
incorporators, stockholders, or other interested parties and when fraud is brought out, it is not tolerated by the courts.

The courts are usually very specific in their language when reference is made to the corporate enterprise. The laws have established the corporation and the courts so interpret the laws. In the Weatherford Ry, v. Granger, 86 Tex. 350, 24 S. W. 795 (1894) case, it was held that charges before a corporation is formed could not be collected from the corporation after it was incorporated. Only those charges that are incurred after the incorporation date are considered collectible. Hence, the corporate entity as set up by the law is extremely difficult to break and "... if at all, only where the entity is formed or used for some improper purpose."

The birth of the holding company in the United States took place in New Jersey when, in 1889, a general incorporation law was passed which permitted corporate enterprises to be incorporated with the express purpose of owning stock in other corporate enterprises. Thus, some corporate enterprises were formed for the express purpose of becoming...

stockholders of other corporate enterprises. However, when control is considered between the parent and the subsidiary corporations, "... the parent corporation will be responsible for the obligations of its subsidiary when its control has been exercised to such a degree that the subsidiary has become its mere instrumentality."

The corporate enterprise of the Roman Empire is quite different from the corporation in Germany. The corporate enterprise was in existence in the Roman Empire and it was called a university. Because the Roman government feared revolts, these universities were licensed. Although the university did exist as a business organization before this time, the license permitted the universities to carry on business activities legally. Thus, the Roman government recognized the corporate enterprise which was in existence and hence, the association theory in law. The German idea of corporate enterprise is perhaps the closest to the entity theory because the corporation almost takes on a real personality. In most of the other European countries, however, the corporate enterprise is a persona ficta.

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49 Powell, op. cit., p. 8.
51 Anderson, op. cit., p. 4.
Several states have passed laws in regard to corporate enterprises which are interesting and worth mentioning.

In Virginia, Negroes who could not own realty according to a covenant in a deed could become owners of property indirectly by purchasing stock in a corporate enterprise. A corporate enterprise, even though it was owned entirely by Negroes, could own realty.52

Maine has a unique concept of capital. Maine law holds that the "... capital of a corporation is a trust fund for the creditors."53 The Maine courts have also decided that premiums received on the sale of capital stock is not surplus but a capital contribution. The attitude of the Maine courts was brought about because the problem arose when dividends were paid because the law stipulated that dividends must be paid out of profits.54 Other states, however, would permit the classification of premiums from the sale of capital stock as capital surplus and even permit the payment of dividends from this capital surplus.


53 Ballantine, op. cit., p. 411.

54 Ibid., pp. 411-413.
Summary. The corporate enterprise is chartered by the state according to state law. The corporation enjoys all the rights and privileges granted by law and exists independently of its stockholders, management, creditors, employees, and the government.

Two theories are found in law pertaining to the authority of the corporation. The fiction theory considers the law of the land as the source of authority and the association theory considers the union of stockholders as the source of authority.

Following the fiction line of reasoning, the corporate enterprise is a separate and distinct entity with the corporation as the important factor and not the interested parties. The stockholders are completely distinct from the corporation and the corporation can even sue the stockholders. The corporation is not merely a method of doing business and can even make donations to institutions over the objections of some stockholders. Because of the physical and financial size of corporations, laws have been passed restricting the corporate enterprise, which laws, however, have no effect on the stockholders. Also, a stockholder cannot bind the corporation but only management or their agents can contract for the corporate enterprise. Whenever the stockholders are held personally liable for the corporation's debts, the courts are not saying that there is generally no distinction
between the corporation and its stockholders, but the courts are saying that in this case there is no separation because of the circumstances.

The association theory is a proprietary approach and has authority coming from the stockholders. Stockholders can be held personally liable for corporate debts for back wages and when the double liability clause is in effect. Under this approach, the corporation is considered as merely a method of doing business. Although the stockholders cannot override management, they can change the directorate or even increase or decrease it. Thus, the new directorate will be more favorable to the stockholders.

The creditors have no positive position in the corporation except in a few rare instances. However, since they loan funds or sell goods to the corporate enterprise, they do possess certain rights. They have the right to demand payment for debts when due and in some cases they can force the corporation into receivership or liquidation.

Corporations that are owned by the government enjoy many special privileges but the courts have held that the corporate entity exists and individuals can sue government owned corporations without asking permission from the government.

Management's duty is to operate the corporation for the interest of stockholders according to the proprietary
theorists or for all interested parties according to the entity theorists. Some management groups have grown in power to a point where they have perpetuated themselves in their positions. Although it is still the right of the stockholders to select and elect the board of directors, some managements have selected the directorate. One of management's functions is to make contracts which bind the corporation. Some hold that the duty of the board of directors is to the corporation and not to the stockholders, which would be an entity approach.

The laws are very specific when they define the corporation as a separate entity. However, the law leaves much room for interpretation of authority when the whole theory of corporate enterprise is considered. The fiction theory follows an entity concept and the association theory follows a proprietary concept.
CHAPTER III

TAX VIEWPOINT

OF THE PROPRIETARY THEORY AND THE ENTITY THEORY

OF CORPORATE ENTERPRISE

Since the passage of the Federal Income Tax law in 1913, taxes have played a more important part in business each succeeding year, and any study of the corporate enterprise necessitates considering income taxes. The tax advantages or disadvantages are always considered when a sole proprietor or a partnership is considering whether or not to incorporate.

There are two methods for taxing the income of corporate enterprises, income tax and capital gains tax. The capital gains tax is the less significant from a corporate enterprise point of view because the larger tax bill is generally on the income. The tax on income—on the profits from the operations of the corporate enterprise—is divided into two parts, normal tax and surtax. The normal tax is the rate levied against the normal income, and the surtax is an added rate levied against the income.

Problem of double taxation. In the income tax laws today, there exists a distinct difficulty which is double taxation. The corporate enterprise pays income tax on all of its taxable income, and when dividends are distributed to the stockholders of the corporate enterprise, they too pay income tax on the income of the corporate enterprise. The paying of income tax by the corporate enterprise and the stockholder on the same earnings distributed to the stockholder is called double taxation.

There are many pros and cons to the problem of double taxation. According to the entity theory, the tax does seem justified because it is being levied against two distinct units. However, according to the proprietary theory, there seems to be an injustice because the tax is levied first on the corporate enterprise's earnings and secondly, the tax is levied on the dividends distributed to the owners of the corporate enterprise which is a discriminatory action between forms of business enterprises. The proprietary theory extremists state that whatever the corporate enterprise owns, the stockholders own. Thus, the income of the corporate enterprise is the income of the stockholders and when this corporate income is taxed, the stockholders of the corporate enterprise are also indirectly taxed because it is their income in the corporate enterprise that is being reduced by the amount of the corporate income tax.
Following are some of the comments made by different authors with respect to the double taxation problem. As can be seen, the comments vary considerably when considering the entity theory, the proprietary theory, the stockholder, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete entity theory and the proprietary theory of corporate enterprise is presented in the eighth chapter.

Double taxation is not equitable. According to the National Tax Association 1947 Proceedings\(^2\) it does not seem equitable to levy an income tax on both the corporate enterprise and the stockholders, since non-corporate enterprises are not taxed on profits. All the business profits are taxed as part of the individuals' income, thus, only one return is filed. In partnerships,\(^3\) each partner is taxed for his share of the profits whether or not the profits are distributed and no matter how many partners there are. At no time is the share of profit taxed again by the government.

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\(^3\) Certain business organizations even though they are considered as partnerships, such as a cooperative, are given special privileges under the tax laws.
One of the major criticisms of the double taxation theory is that the corporate enterprise stockholders and the corporation itself are one economic entity. The stockholders furnish the capital and the corporate managers furnish the managerial techniques. Here, the corporation's charter is considered merely a piece of worthless paper and there is no separate entity but it is just a method of doing business.

A corporation is subject to a double tax. More accurately, when there is a corporation the owners are subject to a double tax. There is a tax on the corporation, and when the owners want to get their money out there is a tax all over again on the same profits. The doubling up will come either in the form of a tax on the dividends that are paid out when the company winds up or when the owners sell their stock in the company. You don't run into a double tax when you have a partnership.

According to the theory of corporate taxation about the year 1939, "The Corporation was thus regarded as a conduit for transmitting earnings from the business to its owners, not as a tax paying unit entirely apart from its owners." The theory has changed today, and now, the entity approach is in effect with a tax on corporate earnings and a tax on the stockholder for the distributed profits received.

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from the corporate enterprise.

After the first World War, the government made an attempt to follow the proprietary theory of corporate enterprise when it divided the income tax on its citizens into normal tax and surtax.

Since the World War the taxes on incomes of citizens of the United States have been separated into two divisions—the normal taxes and the surtaxes, the surtaxes being in addition to the normal tax and graded in accordance with the amount of net income.

When this provision was originally adopted the main reason given for it was that income received from corporation dividends had already been taxed and that to apply the income tax in full to dividends would be inequitable. A recent revenue act, however, made an important change in the law by making dividends taxable in the same manner as other income.7

The new revenue act of 1954 makes an attempt to return in part to the proprietary theory by allowing a $50 deduction to the stockholder for the first $50 of income received from dividends that are distributed by the corporate enterprise. This tax exclusion may be considered as a relief measure rather than a return in part, by the government, to the proprietary theory. The tax credit which is allowed on dividends is 4% of dividends received after July 31, 1954. This 4% credit cannot exceed the amount of

tax to be paid for the year, which is reduced by any foreign
tax credits or 2% of all the taxable income before January 1,
1955 or 4% after January 1, 1955. The $50 dividends exclusion
is not to be used to calculate this credit. 8

No double taxation present. Some authors hold that
the stockholders of corporate enterprises are only the
theoretical sovereign power, and their position is that of
creditors who have given up some of the security of ordinary
creditors in order to obtain greater gains. 9 Although the
stockholder is considered the owner of a corporate enter-
prise, this fact appears only theoretical in the large corpo-
rate enterprise. With so many outstanding shares of capital
stock, the voice of one share in several hundred thousand
is but a whisper. The stockholder when he purchases one
share of corporate stock is looking to the corporate enter-
prise for a return on his investment and his concern with
the actual management of the corporate enterprise is only ex-
pressed when returns on his investment are not forthcoming.
The corporate enterprise has a duty to safeguard the invest-
ment of the owner as well as remunerate him for the funds


being used. The same is true with creditors but the creditors do not expect an extra return on their investment, only the payment of the original debt which usually includes the cost of the goods sold plus a profit. The corporate enterprise from an entity approach has claimants in the creditor as well as the stockholder and anything they receive is a reduction of the corporate wealth. Hence, the payments to the creditor and to the stockholder by the corporate enterprise represent a reduction in the total assets of the corporate enterprise.

If this double taxation feature were eliminated in total or in part, Randolph\(^1\) states, there would be many stockholders who would receive a large sum of dividends and an increase of capital appreciation on the value of their stock which the stockholders never did anticipate. The present condition of double taxation is known by all and expected to continue. Thus if a change in the law occurred it would lead to a new interpretation of the existing tax concept of the corporate entity. Also, Randolph\(^1\) further states, that if the corporate income taxes were to be eliminated, there would be large accumulations of untaxed profits and it would not be practical nor possible in some cases

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\(^{10}\) Randolph, *op. cit.*, p. 354.

to distribute all of the corporate enterprise's profits.\textsuperscript{12} Hence, if a corporate enterprise could be classified as a separate economic entity which would be distinct from the stockholders, according to Randolph,\textsuperscript{13} then it should be taxed substantially.

Considering both arguments. The income tax of 1909 and before the passage of the sixteenth amendment, states the National Tax Association 1946 Proceedings,\textsuperscript{14} was considered as a tax on the stockholder and not a tax on the corporate enterprise as such. However, after the sixteenth amendment was passed, there was introduced a new concept to corporate taxation, and now, the tax is considered as being levied against the corporate enterprise and not a tax on the stockholder. This new attitude was an about-face in the theory of taxation.

Between 1913 and 1935, dividends were exempt from normal tax but not from a surtax in the United States.\textsuperscript{15} Hence, when the normal tax rate for corporations and the

\begin{flushleft}
\textsuperscript{12} There is always the possibility of reducing the price of the product which in turn would reduce future income.
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\textsuperscript{13} Randolph, \textit{op. cit.}, p. 373.
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\textsuperscript{15} Blough, \textit{op. cit.}, pp. 314-315.
\end{flushleft}
normal tax rate for individuals is the same and either the corporate enterprise's income or the dividends received by the stockholder are exempt from normal tax, there is no double taxation problem.

The corporate income tax is levied on the source and with a tax on the dividends which the individuals receive, the stockholders are being taxed twice on that part of the income which is returned to the stockholders in the form of cash dividends. A different rate between the stockholder's normal tax and the corporate normal tax with the corporate lower would reduce some of this double taxation. Although part of the tax would be double, the total tax paid by the stockholder and the corporate enterprise would not be twice the normal tax of the stockholder. Thus, some relief is offered to the stockholder.

A possible solution to the problem of double taxation would be to eliminate the corporate tax on income and consider the distribution of profits from the corporate enterprise along with all undistributed profits as income to the stockholder. In this way, the treatment of income taxes would be the same as that which now exists for the sole proprietor and the partnership. Hence, there would be no double taxation problem because taxes would be assessed

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16 Ibid., p. 316.
directly on the stockholder. This solution would, however, cause many other problems—an example being record keeping—and such a solution does not seem too practical.

If all the dividends of the corporation could be treated as interest expense, there would be little trouble and the investor would be quite satisfied. If all the dividends of the corporation could be treated as interest expense, there would be little trouble and the investor would be quite satisfied.17 It would alleviate a great number of problems when a corporate enterprise is considering the possibilities of new capital. Hence, for tax purposes, the corporate enterprise would not be considered a separate entity but only a method of doing business.

The consideration of interest as an expense and dividends as a distribution of profits, Seligman states, is strictly a tax point of view. From an economic standpoint, the distribution of dividends and interest would be a return on the investment and hence, a distribution of income. The law allows the deduction of interest but it does not allow the deduction of dividends. It is understandable why some economists hold that there is little difference between the stockholder and the bondholder; contributors of capital

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19 Frank H. Knight, Risk, Uncertainty and Profit (Boston: Houghton Mifflin Company, 1933; Re-issue), pp. 300-301, and 350.
are concerned because both receive as payment for funds advanced to the corporate enterprise a division of the corporate enterprise's income.

Deductions that are allowed for income tax purposes are only those which are necessary to produce income or which cause losses. But, there is a distinction made between the income that is obtained from borrowed capital and that which is obtained from equity capital. Interest on borrowed capital is a deductible expense but dividends, which have the same function as interest as far as the corporate entity is concerned because the dividends constitute a charge for the use of money and from the stockholder's point of view it is a return on his investment, are not deductible expenses.

**Stockholders.** The equity of the stockholders in a corporate enterprise is represented by their capital contribution and retained earnings. The capital contribution is the capital stock plus any paid-in-surplus; the accumulation of past profits in the retained earnings account is what has cause the greatest problem from a tax point of view. Dividends are a reduction of the owners' equity in the

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corporate enterprise.

The stockholders "... have inchoated ownership of the corporate assets and earnings, but that is quite different from the direct type of ownership enjoyed by partners." Therefore, the corporate enterprises "... have become economic reality protected by law."  

**Bondholders.** The bondholders are little concerned with the dispute about double taxation. The interest paid to the bondholders is a deductible expense for the corporate enterprise and the income received by the bondholders is taxable to them. The position of the bondholders is one that the stockholders would like to have as far as income taxes are concerned because then, according to the proprietary approach, their income would not be taxed twice.

**Management.** Today, in the study of the corporate enterprise and the theories that have been presented in the last twenty years, is found a great deal of confusion. However, one thing is certain and it is that in the case of the large corporate enterprise, there is a division between ownership and management. This positive division of ownership and management has led the writers in the tax field

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22 *Loc. cit.*
to follow the entity approach to the problem and deem that there is distinctly an income tax levy on two separate units. Randolph\textsuperscript{23} presents the following comments on the subject.

Do the stockholders have a real voice in the formation of important corporate policies, such as wages, price and dividend policies? Does the fact of incorporation bestow substantial economic advantage, such as accessibility to national, and perhaps world, capital markets? Are corporate characteristics—such as limited liability of stockholders, easy transfer of ownership and perpetual life—essential to the very manner of doing business? These attributes suggest the economic separateness of the corporation and justification for a corporation tax.

Before the twentieth century, the problem of income taxes was nonexistent because there was no income tax on the corporate enterprise and the managers of the corporate enterprises were usually the owners. The problem arose, however, with the introduction of income taxes on personal and corporate incomes and the divorce of management and ownership.

In cases where management is paid a percentage of the profits for their efforts, this extra salary is tax deductible for the corporate enterprise. Even though this salary is admitted by the corporate enterprise as a distribution of the corporate profits, it is still tax deductible for the corporate enterprise as a portion of the gross salary of the officers. There is no reason why, Goode\textsuperscript{24} states,

\begin{itemize}
\item \textsuperscript{23} Ibid., p. 373.
\item \textsuperscript{24} Goode, \textit{op. cit.}, p. 17.
\end{itemize}
the management of corporate enterprises should not receive this added compensation for superior managerial skill. This extra remuneration which is calculated as a percentage of the profit increase of the corporate enterprise is paid as a reward for superior management and it is also an inducement to increase the efficiency within the corporate enterprise. Even though this extra remuneration to management is calculated on the added profits of the corporate enterprise because of management's efficiency it is considered as a cost to obtain higher profits and hence, tax deductible.

**Employees.** The employees of a corporate enterprise are little concerned with the corporate income tax. The wages of the employees are deductible expenses of the corporate enterprise. However, some have claimed that if the proprietary theory was to be invoked in taxing the corporate enterprise, the employees may benefit by a higher wage which would be made possible because of the reduced tax. This contention, however, does not seem likely.

**Government.** The purpose of income taxes is to obtain money in order to operate the government. The basis for the tax levies, Magill\(^{25}\) states, is on the privilege to do business

\(^{25}\) Magill, *op. cit.*, p. 128.
and not on the ability to pay. Some economists hold that the income tax is levied on the corporate enterprise because the corporation is in a position to pay, and hence, the injustice of double taxation can be excused only by the fact that the government needs the revenue and the difficulty in raising it elsewhere.

Miscellaneous. There are many other comments that have been made with regard to the income tax on corporate enterprises. Some of these statements follow.

Goode points out that Great Britain, Australia, New Zealand, and other countries of the world which have an income tax, have integrated the corporate and individual income tax. These countries have adjusted the rates so that the proprietary theory of ownership is followed. The relief from the payment of the normal tax by both the stockholder and the corporate enterprise is in force and hence, a normal tax is paid by one party only and it is usually the corporate enterprise.


\[27\] Green, op. cit., p. 59.

\[28\] Goode, op. cit., p. 9.

\[29\] Magill, op. cit., pp. 122-123, points out that Great Britain has a normal tax paid by the corporate enterprise and the rate is the same as the rate paid by individual
Although the stockholders of large corporations clamor for relief from the double taxation problem they are quite satisfied with the protection given them by the corporate enterprise laws of the country. The corporate enterprise is a separate entity established by law and as such is taxed by the federal and state governments.

**Summary.** Taxes play a large part in the corporate enterprise. In the tax laws today, some people believe that income taxes on the corporation result in double taxation. Income taxes are levied first on the corporation and, when dividends are declared and paid to the stockholders, the stockholders are taxed again on the dividend income. Hence, the corporation pays a tax on its income and the stockholder pays a tax on his income received from the corporation which has already been taxed.

A double tax is not equitable. In the partnership or sole proprietorship, the income of the business is only taxed once. The stockholders are the owners, following a proprietary approach, and hence, there is discrimination between forms of organizations. Also, the corporation is considered taxpayers. When dividends are paid by the corporate enterprise to its stockholders, the tax on the dividends is paid by the corporation so when the stockholder reports this dividend income he is given a tax credit on the normal tax and he must pay only the surtax on the income received in dividends.
merely a method of doing business with the corporate charter merely a piece of worthless paper. The tax laws do provide room for believing double taxation is practiced, because in the first years of income tax the stockholders were exempt from paying the normal tax on dividends received from a corporation. This has changed, and in the recent tax law the stockholder is given a dividend exclusion and tax credit for dividends.

Following an entity approach, there is no double taxation situation, because the tax is levied on a separate and distinct entity which can be so identified. The law permits deductions which are necessary to produce income or which cause losses. Dividends are not considered deductible but interest on borrowed capital is a deductible expense.

The stockholder is in the middle of the problem and following the proprietary theory he is being unjustly treated. However, according to the entity theory there is no injustice.

Management has taken over the reins of operating the business. The salaries received by management are deductible for income tax purposes even though the compensation is considered a distribution of corporate profits. The managements are not only the operators of the corporate enterprise but they are also creditors for their salary.

The creditors and employees are also creditors of the corporate enterprise and the stockholders would prefer a
position of creditor for tax purposes, because dividends would be deducted as an expense rather than being considered distributed income.

The government is a tax collector and does not try to apply the entity or proprietary theory, because the purpose for income taxes is to obtain money in order to operate the government.
CHAPTER IV

INVESTMENT VIEWPOINT
OF THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

Do the stockholders of a corporate enterprise really own the corporate enterprise or are they just investors?\(^1\) In large corporate enterprises it would seem foolish to think that a stockholder with one share of stock out of several thousand shares outstanding would have an effective voice in the corporate affairs. But ownership means the right to possess or at least to have a voice in the management of the corporate enterprise, and each stockholder who owns voting stock does have a voice in the corporation even though that voice may not always be heard.

Following are some of the comments made by different authors with respect to the theory that the stockholder is an owner as opposed to an investor. As can be seen, the comments vary widely when considering the entity theory, the proprietary theory, the stockholder, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete

\(^1\) Stockholders as mere investors implies that the stockholder is a type of creditor.
entity theory and the proprietary theory of corporate enterprise will be presented in the eighth chapter.

A corporation is a voluntary association of persons, natural or legal, organized under and recognized by the law as a person, fictitious in character, having a corporate name and being entirely separate and distinct from the persons who compose it, for the accomplishment of some specified purpose or purposes. It has continuous succession during the period of life assigned by its charter and the right to perform as a natural person all the functions expressed in its charter, or implied thereby, or incidental there­to.

This definition brings out the fact that a corpo­ration is not an organization formed by the state, as many say, but it is one formed by persons in accordance with the provisions of the state laws, and then duly recognized by the state as a corporation.²

The above definition of the corporate enterprise favors the association theory of entity as stated in law or the more common term, proprietary theory of corporate enterprise.

The term securities as used in financial circles can mean capital stocks or bonds or both. The ownership in a corporate enterprise is evidenced by a stock certificate and the debt of a corporate enterprise is shown by a bond cer­tificate. Hence, because one owns securities does not mean he owns a part in the corporate enterprise unless these securities are capital stocks.

In past years, Daniels relates, the term liabilities applied to all accounts on the right-hand side of the balance sheet which would include the owners' equity section. As theory progressed, the accountants and businessmen realized that the capital stock of the corporate enterprise did not represent a liability in the same manner as the other claims but that the liability of the owners' equity was just an accountability trust. Thus, the introduction of the many new words—net worth, capital section, owners' equity, invested capital, and so forth—served to represent the owners' equity section of the balance sheet and the presentation of the balance sheet with a division between liabilities and net worth.

Douglas, Skar, and Price present the following comparison between a corporate enterprise and a partnership.

Corporation

1. Exists in its own name as an individual.
2. Has continuous existence regardless of change in stockholders.
3. Stockholders have limited liability.
4. Obligations arise only from acts of agents or officers.
5. Profits belong to the corporation until dividends are declared.

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Partnership

1. Exists as a group of individuals. The members, as such, constitute the partnership.
2. Automatic dissolution arising from death, withdrawal, or incapacity of a partner.
3. Each partner has unlimited personal liability.
4. Obligation arises from the acts of any partner.
5. Profits belong to the individual partners as soon as earned.4

It is interesting to note, especially, the fifth comparison made by the authors. The partner has title to the profits of the partnership but the stockholder has no claim on profits and receives no remuneration until dividends are paid. According to some followers of the proprietary theory, the stockholder is a claimant to the assets subject to the debts and the theory resembles the theory of partnership. However, there is a marked distinction when ownership and profits are considered, and the theory of corporate enterprise then leans toward the entity approach.

Although the stockholders may try to use the corporate enterprise for a front, this does not mean that a corporate entity exists. In such cases, a corporate enterprise will be considered not as a legal entity by the courts but as a partnership or a sole proprietorship whichever the case may be. The courts are very emphatic, in cases where stockholders try to use the cloak of incorporation for their

own personal gains.\textsuperscript{5}

When ownership is considered in sole proprietorships and partnerships, the sole owners or partners have title to the property of the business. In the corporate enterprise, however, the title to the property is in the hands of the corporate enterprise and the stockholders in turn possess title to the corporation.\textsuperscript{6} The corporate enterprise owns all of the property whereas the stockholder owns only a pro rata share in the corporate enterprise according to the number of stock shares in his portfolio. This pro rata share in the corporate enterprise is in turn a pro rata share in the total assets less debts and income of the corporate enterprise.

The term capital is defined in numerous ways when it refers to corporate enterprise.

In the accounting and investment sense, capital means the excess of the assets over the liabilities. This definition applies whether the organization is a corporation or some other type such as a partnership or individual proprietorship. Capital in the business sense, however, is used to mean the total assets of the business organization. Capital in the legal sense is usually interpreted as the par or stated value of the capital stock.\textsuperscript{7}

\textsuperscript{5} Elvin R. Latty, \textit{Subsidiaries and Affiliated Corporations} (Chicago: The Foundation Press, Inc., 1939), pp. 5-6.

\textsuperscript{6} Edwin W. Boehmler and others, \textit{Financial Institutions} (Chicago: Richard D. Irwin, Inc., 1951), P. 213.

When Kamm defines capital in the accounting and investment sense, he uses the proprietary approach because capital is assets less liabilities or to use the equation, \( A - L = C \). Capital as used in this sense represents the residue in assets after the liabilities have been deducted. Capital in the business sense is equivalent to the entity theory because the stress here is on the assets of the corporate enterprise. The liabilities to the creditors and the equity claims of the stockholders are against the assets collectively or the equation \( A = L / C \), according to the entity theory of corporate enterprise.

Shultz\(^8\) contributes the following concept of capital.

In the financial world the term "capitalization" means the aggregate dollar amount of the various securities issued by a company, including bonds, preferred and common stock; the term "owners' capital" means the investment represented by the stock issues and surplus; the term "capital structure" means the division of the capitalization as between bonds, preferred stock, common stock, and surplus. Gross capital is the total amount invested by everyone—bondholders, stockholders, trade creditors, etc.

Thus, gross capital as used by Shultz would define the entity approach to the corporate entity.

In considering the contributors of capital the term modern corporation or modern industry is being widely used today. The term became famous after the publishing of Berle


Modern Industry is largely indirectly owned: investors own corporations, and corporations own the physical properties employed in producing goods and rendering services.9

Thus, Burtchett brings out the new look in corporate enterprise theory which was introduced by Berle and Means. This new look is an entity approach and from an investment viewpoint, the stockholder has taken the position of merely an investor (creditor) rather than a true owner. The investor owns an interest in the corporate enterprise and because of this ownership has a vested interest in the assets of the corporate enterprise but he does not own the assets. The assets are owned by the corporate enterprise only.

Stockholders. The actual ownership in a corporate enterprise is represented by stock certificates and the rights attached thereto are defined in the charter of the corporate enterprise. The interest of the stockholder in the assets and earnings of the corporate enterprise are in direct proportion to the number of shares owned. However, one stock certificate may be issued for one or more shares of stock.

As long as a corporation is profitable, the stockholders, both common and preferred, are entitled to share in the distributed profits of the corporate enterprise according to their pro rata share of ownership. Even though the stockholders may not share in the earnings because dividends are not declared, the surplus account is credited with the profits and hence, in most cases, continued accumulation of earnings may cause an increase in the price of the capital stock on the securities market. If earnings are high, the price of the capital stock will usually advance and if earnings are low the price of the capital stock may decline. There are other factors which may cause a rise or fall in the stock market prices but earnings are an important consideration.

Preferred stock and common stock are the two classes of capital stock issued by a corporate enterprise. "Common stock represents ownership pure and simple, ownership unrestricted by special limitations and uncomplicated by particular privileges. Preferred stock is ownership with preference but also with certain limitations." Since the preferred stockholder has been given preferential treatment,

10 Shultz, op. cit., p. 46.

the common stockholders stand the greatest risk because they receive dividends only after the preferred stock obligation is met. The common stockholder usually receives the largest gain because he is not limited to a percentage of capital investment as the preferred stockholder; conversely, the common stockholders are liable to suffer the greatest loss because of the uncertainties of business. Also, the common stockholder is the last recipient when a corporate enterprise is being liquidated.

A comparison between a corporate enterprise and a partnership reveals that the partners supply most of the capital, or in some cases, all of the capital in a partnership and they usually receive all of the gains and suffer all of the losses. In a corporate enterprise, however, the individual stockholders usually supply all of the total capital contribution made to the corporate enterprise, but the stockholder receives only his proportionate share of the gains when dividends are declared and his losses will be only to the extent of his capital contribution.  

One of the greatest advantages of the corporate form of business organization is the limited liability feature, although in specific cases it may be a disadvantage. Usually,  

the only amount a stockholder can lose is his capital contribution. A partnership has unlimited liability but "... it is possible in most states to limit the liability of partners through formation of a limited partnership; but even here, there must be at least one partner who has unlimited liability." Although the partnership must have one member with unlimited liability, the stockholders all have limited liability in a corporate enterprise. The corporate enterprise, on the other hand, has unlimited liability.

The authors in the field of investments follow either the entity theory or the proprietary theory of corporate enterprise. Following the entity theory reasoning, the authors hold that the position of the stockholder is quite similar to the other contributors of capital or stated another way, the stockholder is just an investor in the corporation. The proprietary theory which is held by some authors is presented with the idea of ownership of the corporation as such by the stockholders. Both theories are included here with comments by the various authors.

**Entity theory.** Leavitt and Hansen in their book, *Personal Finance*, say, "In a sense, ownership of a business

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corporation is divided between two groups of people; stockholders and creditors.\textsuperscript{14} This is directly in line with the entity theory because ownership is not limited to the stockholders.

Boehmler and others in their book, \textit{Financial Institutions}, present the following description of stockholders.

A very large proportion of stockholders are inarticulate as owners. They do not seek to have a voice in management, do not attend stockholder meetings, and often do not trouble to send in a written authorization (called a 'proxy') delegating some other person to vote the stock for them at the meeting. Their motivation is undoubtedly found in the hope of income and appreciation in value rather than in managerial ambitions. In effect, the great mass of stockholders conduct themselves more nearly like creditors than owners. In fact, this is but a manifestation of the separation of ownership and control (management) that has so frequently been noted as characteristic of our times. For this reason some writers have called stocks 'investment credit instruments.' The true nature of stock should, however, be clearly understood—they represent ownership, not credit.\textsuperscript{15}

The authors do imply that the stockholders' position is quite similar to the creditors because of their own actions although the legal fact is the stockholders do own the corporate enterprise.

Considering the stocks and bonds of the corporate enterprise, Burtchett says,

\begin{itemize}
\item \textsuperscript{15} Boehmler and others, \textit{op. cit.}, p. 222.
\end{itemize}
Between stocks and bonds there exist differences both of a legal and an economic nature; there are, some overlappings. While it is true that shares are evidences of ownership and bonds are credit contracts, it must not be forgotten that both are legally regarded as being contracts and that both exist between the corporation on the one hand and the shareholder or bondholder on the other.

The retention of earnings by the corporate enterprise, according to the literature on corporate finance, deprives the stockholder of the right to decide which is to be the best disposition of the funds that have been retained by the corporate enterprise. In a great many cases, the stockholders would prefer receiving the retained earnings in the form of dividends but the power exercised by the majority of individual stockholders is indeed small in the large corporate enterprise because of their passive attitude.

When a stockholder invests in a corporate enterprise, there is never a promise to return the invested capital at any time by anyone. If the stockholder wishes to regain his original investment, he can sell his stock to some other person or in some cases, the corporate enterprise may be liquidated and then the stockholder will receive his pro

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16 Burtchett, op. cit., p. 140.


18 Sauvain, op. cit., p. 21.
rata share of the corporate assets along with the other stockholders. If the corporate enterprise was merely a form of doing business, the stockholder would not have to wait for the corporation to declare the dividend. The declaration of dividends would be only a formality. However, with the corporate entity in existence, the stockholder must wait for the declaration of dividends by the corporate enterprise and this procedure fosters the entity theory.

**Proprietary theory.** Burtchett defines the stockholder's position in the following way. "The owner of one of these shares is a partial owner of the proprietorship interest; but he is not a partial owner of the corporation's assets. The stockholders collectively own the corporation which, in turn, owns the assets."\(^{19}\)

Louis Engel, in his book, *How to Buy Stocks*, says,

The stockholders of America are the people who own, operate, and finance much of its business—virtually all its more important business. As that business has grown, stock owners have prospered. As it continues to grow, they will continue to prosper.\(^{20}\)

One can add that as the business decreases, the stockholders will suffer the losses.

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\(^{19}\) Burtchett, *op. cit.*, pp. 118-119.

An investor in a company who has one share has just as much ownership as any other share. With the one share, the stockholder is a part owner of the business and with the other stockholders he becomes an owner in common.\textsuperscript{21} The rights per share of capital stock are equal but it is the number of shares owned in a corporate enterprise which determines who controls. The capital stock of a corporation represents the actual ownership of a corporate enterprise.

The holders of capital stock own the equity in the assets which remain after the debts of the corporation are paid. Capital stock, therefore, means proprietorship, ownership, or per cent control of the business. A share is a fractional interest in the equity of a corporation.\textsuperscript{22}

Although stocks and bonds represent contributions of capital to a corporation, they are entirely different in nature. The stockholder in a sense owes the bondholders because the stockholders' capital contribution will be used to pay the debt if the obligation cannot be met from operations although the bonds are a corporate obligation.\textsuperscript{23} The purchase of stock by an investor is not a loan to the corporate enterprise but it represents ownership of the corporation's

\textsuperscript{21} Ibid., p. 8.
\textsuperscript{22} Shultz, \textit{op. cit.}, p. 43.
capital stock.

Engel states the difference between stocks and bonds quite simply when he says,

The man who buys stock in a company actually buys a part of that company. The man who buys a company's bonds simply lends his money to the company. The stockholder expects to collect dividends on his stock and thus share in the company's profits. The bondholder expects to earn a fixed return on his investment in the form of interest payments.\(^{24}\)

Although the majority group of stockholders are in a position to rule in the large corporate enterprise because of the total number of shares owned, the minority group of stockholders usually are the ruling body because of the passive attitude of the other stockholders. The stockholders maintain control of the corporate enterprise through the board of directors whom they elect. With the great dispersion of ownership in the large corporations, a small concentration of votes can control the election. The results of this dispersion of stockholders has caused a few stockholders to exercise their right to vote and few investors are interested in corporate affairs as long as the dividend check keeps coming, and hence all parties are usually happy. This passive attitude of the stockholders has caused the concentration of power in the hands of a few who are able to rule

\(^{24}\) Engel, *op. cit.*, p. 34.
the corporate enterprise by setting up a board of directors of their own choosing, and thus, control the corporation, which is not directly related to their proportionate share of ownership.\textsuperscript{25}

When the stockholder tries to maintain control in a corporate enterprise, he is confronted with many difficulties. The stockholder transfers to the directors of the corporation his right to operate the corporate enterprise, and the directors in turn, transfer the responsibility to the officers of the corporation. "As a result, the extent to which the owner has lost control and the present location of that control are matters of general social concern."\textsuperscript{26}

**Creditors.** The sale of bonds by a corporate enterprise represents an obligation of the issuing corporation. The obligation is to repay the principal and a stated amount of interest within a given length of time. The corporation has borrowed the money from the bondholders and the corporate enterprise must pay back to the bondholders the amount borrowed plus all the interest which the bondholders are entitled to—the amount of redemption is the stated value or face value if the bonds are redeemed at maturity but at

\textsuperscript{25} Purdy, Lindahl, and Carter, *op. cit.*, pp. 72-73.

\textsuperscript{26} Ibid., pp. 61-62.
any time preceding that date, there may be a premium or
discount to consider.

The interest of the bondholders must be paid whereas
the dividends of the preferred stock and common stock may
be passed. The interest payment is a direct obligation of
the corporation to the bondholders. However, if the direc­
tors decide not to pay dividends, the stockholders will
receive no return on their investment. As long as there is
money to pay interest, this obligation will be met by the
corporate enterprise. Failure to meet this obligation may
result in forced liquidation of the corporation. Failure
to meet the anticipated dividend declaration, if a policy
of annual dividends has been adhered to in the past, will
not affect the corporation directly because the stockholders
cannot force liquidation when the corporate enterprise does
not declare dividends whereas the bondholders can force dis­
solution if interest payments are not made.

The holders of corporate bonds are creditors of the
issuing corporate enterprise. The claim of the bondholders is
against the assets of the corporation and the bondholders have
priority over the stockholders in case of liquidation. When
bonds of a corporate enterprise are secured, the claims of
the bondholders are against particular assets and are before
the other general creditors.
The creditors of a corporate enterprise, Boehmler states, are in a poorer position than the creditors of a partnership in that the creditors can look only to the assets of a corporation for payment but in a partnership, the creditors can look to the assets of the partnership and all the free assets of each individual partner. Therefore, the position of the creditor would depend directly on the assets of the corporate enterprise or partnership.

Liabilities are "... obligations of the enterprise; equities in the assets other than interests of stockholders, (or other proprietary interests)." Daniels would give to the owners of the liabilities against the corporate enterprise a vested interest which is equivalent to the claims of the stockholders. The only rights which the debtors do not possess would be a claim to the dividends of the corporation along with the right to vote and the preemptive right which all stockholders do not possess.

The plan of customer-ownership of corporate enterprises has gained much impetus in certain fields in the last few years. The greatest evidence of the plan is in the electric

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27 Boehmler, op. cit., p. 211.
28 Daniels, op. cit., p. 2.
power and light utilities. However, industrial corporations have sometimes tried this method of ownership and the best example is the United Drug Company. The Rexall Drug stores are privately owned organizations but they have affiliated themselves with the United Drug Company, through the purchase of the corporation's capital stock. In the grocery business the small neighborhood stores have had to join together into larger groups in order to compete with the large chain stores. The Nation Wide Stores is such an example of independent grocers joining a national organization. Because of such practices, the corporation could be in a better position financially if the customers were stockholders for when the corporation became financially embarrassed, the corporate enterprise could look to its owners, especially the customer-owners, for assistance. The possibility for aid could be quite good because the customers have a double interest in the corporation, one as a customer and one as an owner.30

Management. One of the greatest rights of the stockholder is his control over the management of the corporate enterprise. In large corporations this control is not evidenced because of the large number of stockholders but there

30 The plan for customer-ownership would also apply to creditor-ownership.
are groups within the corporation who exercise the control and often there are proxy battles to unseat the faction in power. Although the stockholder can exercise control over the management, as a stockholder he cannot transact business in the corporation's name even if he owns one hundred percent of the capital stock outstanding. "Because of this separation, a wedding of 'money and brains,' not always possessed by the same person, is feasible."31

Before the securities and exchange laws were passed, most of the stockholders were not in a position to know what was going on in the corporate enterprise in which the stockholders owned stock.32 The management and the directors had a day to day account of activities but financial statements were seldom if ever published. When statements were published they were confusing to the stockholders and there were few if any requirements to conform to uniform standards. After the SEC was born, requirements were set up to protect the stockholders from the abuse that might exist because of unscrupulous officers and directors.

Although the corporation is owned by the stockholders, "... their right to manage the corporate affais must be

31 Bosland, op. cit., p. 58.

exercised through the board of directors." Thus, the entity theory might be favored here because even though the stockholders own the corporate enterprise they cannot exercise the power of control over the corporation directly.

Berle and Means\(^{34}\) point out that some states have provided in their corporate laws provisions which would permit the election of the directors by the bondholders and by the employees of the corporation. In most states where a corporate enterprise has been in financial difficulty, the bondholders may usually elect the whole board of directors until the interest which is owed them is paid and the corporation is apparently out of danger. The bond indenture will usually set the rules governing the rights of the bondholders along with the state laws governing the sale of bonds.

Although the rights of the stockholder are defined in the corporate charter, his right to the earnings in the corporation, which is pro rata according to the number of shares owned, is determined by the board of directors who order the payment of dividends.

\(^{33}\) Leavitt and Hansen, \textit{op. cit.}, p. 337.

Employees. A new policy that is being adopted in the corporate enterprise is to have employees purchase the corporation’s capital stock so that the employees may become an integral part of the organization. As stockholders, the employees will benefit indirectly because of their efforts as employees. Savings on the part of employees may be reflected in increased profits for the corporate enterprise and as stockholders, the employees’ dividends may be increased because of the greater corporate profits.

Because of the uncertainty of the stock market, management has not fully endorsed the stock purchase plans for the employees, nor have the employees looked with great favor to the idea. When the day arrives that capital stock prices are relatively stable, there may be a large increase in the employee-ownership idea. However, some companies have set aside funds to repurchase at a fixed price the capital stock which the employees own. Also, some corporations have set up special classes of stock just for employee purchases and this stock is not traded on the market but does earn a return. This is also a proprietary idea with the stockholders trying to bring the employees into the field of owners.

Dividends. The stockholder, when he purchases capital stock does not purchase a right which guarantees that dividends will be paid. 36 There is not a promise or a right in the nature of a stock issue in regard to the payment of dividends. However, the stockholder does have a right to dividends when they are declared but not until that time is reached. In case of preferred stock dividends over common stock dividends, the relationship is not a right but only a preference with preferred stockholders receiving their dividends before the common stockholders. This is a preference as to payment of dividends when declared but nothing compels directors to declare dividends. There is one exception to the rule because "... the courts of equity have required corporations to pay dividends to stockholders when failure to do so was clearly unjustified and inequitable." 37

The laws of the land will not compel a corporate enterprise to pay dividends when earnings are large unless the stockholders can prove bad faith among the directors. 38 Usually, when the directors wish to retain earnings for the

36 Sauvain, op. cit., p. 21.
37 Loc. cit.
38 Bosland, op. cit., p. 54.
benefit of business, the courts will allow such practices.  

Some people are under the impression that by investing in common stock they will make a fortune. However, 

There is nothing inherent in stock which will cause it to earn dividends or go up in price in the market. When a business incorporates there is no reason why the owners will earn more on their equity than they did before incorporation.  

Following the entity theory, the stockholder invests in the possible action of another and the profits accruing to the stockholder will depend on this other impersonal being, the corporate enterprise. 

The dividends on preferred stock, Badgar and Guthmann\(^{41}\) state, may be considered as part interest and part profit.  

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39 In the Dodge v. Ford Motor Car Co., 204 Mich. 459 (1919) the court ordered dividends paid to the stockholders. The court decided that the minority stockholders were being unjustly treated and since there were sufficient profits, dividends must be distributed to the stockholders. In Jones v. Van Heusen Charles Co., 246 New York Supp. 204 (1936) the court allowed the recovery of salaries from the directors during the period that dividends were not paid. The court also ordered the payment of dividends to the stockholders.  

40 Donaldson, op. cit., p. 378.  


42 There is also the theory that even with common stock the dividend should be considered as part interest and part profit.
Preferred stock represents ownership but the rate of return on the investment is fixed—in participating preferred stock the regular or fixed return is paid plus a percentage of the profits remaining after the common stockholders have been paid their proportionate share—as is the interest rate on bonds. Thus, the average investor probably thinks that the return on preferred stock is a return on his capital investment, as he would think if he owned the bonds of a corporate enterprise.

Maynard, Weidler, and Burley wrote in their book, _An Introduction to Business Management_, the following about the stockholder.

Common stock is also residual as to dividends. Preferred stockholders have prior claims to amounts available for distribution to stockholders to the extent and in the same manner prescribed by the corporation. All other dividend funds go to the common stockholders. Thus, it may be said that the rights of common stockholders are junior to both bondholders and to preferred stock owners, in assets, and junior to preferred stock owners in the case of dividends.43

With the investment in common stock and preferred stock comes the risk of loss. The return on common stock is usually the highest with preferred stock second and the corporate bonds last. The degree of risk involved in the

investment is just the reverse which accounts for the greatest potential return going to the common stockholders since their risk is the greatest.

The reason many people invest in common stocks—thus becoming owners of a proprietary interest instead of creditors by investing in bonds or lending their money—is the hope for a higher return on their investment. Most people are unwilling to bear the risk of ownership unless they can expect the maintenance of the original investment and secure a return on the investment commensurate with the risk involved.⁴⁴

Stock dividends can be considered from two separate points of view. A dividend in stock will increase the capital account by the amount of the dividend and it usually satisfies the stockholders because they do receive something even though it is just on paper, Shultz⁴⁵ states. However, the corporation could sell new securities instead of retaining the earnings in order to increase the capital account but in this case, the stockholders' pro rata share would be reduced in the corporation if the stockholder did not purchase additional shares.⁴⁶ Either way, stock dividends


⁴⁵ Shultz, op. cit., pp. 46-47.

⁴⁶ With the pre-emptive right attached to the capital stock, the new issues of capital stock must first be offered to the stockholders. Thus, they may retain their proportionate share in the corporation.
or the sale of new securities would not affect the objective of the corporate enterprise.

The participation of the stockholders in the dividends of the corporation, Badgar and Guthmann relate, results from a residual and not a fixed claim. The dividends are a distribution of the profits which are residual in nature whereas the interest paid to the bondholders, noteholders, and other interest claimants represent a direct claim against the income of the corporate enterprise. The interest along with the other expenses of the corporation must be deducted from gross income before the net income can be determined and hence, to see if dividends can be distributed to the stockholders.

Miscellaneous. The reason why a corporate enterprise is organized and, generally speaking, the reason for its continuation is "... that a profit will result; and from this profit the stockholders—the corporation's creators and their successors—may derive a benefit." No matter which theory you consider, either the entity theory or the proprietary theory, the ultimate goal is usually a profit.

47 Badgar and Guthmann, op. cit., pp. 64-65.

When dealing in the study of the credit market, it is wise to consider the stockholder as a creditor. The creditor's viewpoint would be considered superior here because when a corporation is considering borrowing new capital, it can either issue new stock or issue bonds. The operation is one of credit and not the idea of securing new or more owners. The funds are needed and a way out is being considered. The persons purchasing the stock, Machlup relates, would not be looked on as new entrepreneurs but as creditors. However, their rights are the same as the old stockholders and the funds supplied are equity capital but the purchase is still considered from a credit point of view as a borrowed feature. Also, when an investor purchases stocks or bonds of a corporate enterprise, he usually considers his action as being a loan and not an entrepreneurial function even if he purchases stock.

Under the common law code, the right to vote was given to the stockholder and not to the stock itself. Thus, a stockholder owning one share of capital stock had one vote and a stockholder owning one hundred shares of stock had but one vote. However, statutory laws were passed which gave the right to vote to each share of stock held and if

one hundred shares of stock were owned, the stockholder had one hundred votes. Under the old common law interpretation of stock ownership, the proprietary theory was followed when the vote was attached to the stockholder and not to the capital stock. The state as such did not give the corporate enterprise anything but it was the stockholder who transferred his rights to the corporation, thus giving it the right to operate after being recognized by the state. The corporation was an association of stockholders.

Although the corporation is a separate entity and is treated as an individual in the eyes of the law, the states have passed laws which go above and beyond the laws which cover the regular individual. These laws do not affect the stockholder but only the corporate enterprise. Hence, the separateness of the corporation and thus, the entity theory of corporate enterprise is further exemplified in the laws of the land.

In dealing with the corporate enterprise concept, Bosland relates, it is imperative that the stockholders exist, because without stockholders there is no corporate

50 Kamm, op. cit., p. 128.


52 Bosland, op. cit., p. 51.
enterprise. Perhaps those most concerned with the corporation outside of the stockholders are management. However, a corporation, as such, does not need a management group for its existence but it must have stockholders to be a corporate enterprise.\(^5\)

The life of the corporation is usually unlimited except when a limitation is placed on it in the charter or by state or federal law. Hence, if the life of the corporation is greater than that of the stockholder, the corporate enterprise would seem to be greater as to existence at least. The individual stockholders may continually change but the corporation can go on forever. Hence, the authority received by virtue of the proprietary theory would be constantly changing with a change in the stockholders whereas according to the entity theory, a change in the stockholders has no effect on the corporation because authority to act is state given.

The corporate enterprise as a separate entity receives money to operate from the stockholders of the corporation and from bondholders with the current liabilities supplying the short term credit. The suppliers of the

\(^5\) There must be a management group if the corporation is to operate unless the stockholders perform this task. However, the stockholders would then be performing the functions of management.
investment capital—stockholders—may regain their cash investment at any time by selling their stock on the open market. The stockholder will receive a price for his capital stock which may be higher or lower than his original investment. This transaction has no visible effect on the corporate enterprise and the entity continues to do business as usual. The corporation will now have a new investor or owner and there is no visible change in the organization. There may be some effect upon the corporation which would result because of the influence of the new owner or the loss of the old owner as well as the amount of stock purchased or sold. However, the entity as such does not change. If such a transaction was made in a partnership, the partnership would be dissolved.

**Summary.** Two major points are brought out and they are, first, that the stockholder is an owner, and secondly, that the stockholder is a mere investor (creditor). The idea that the stockholder is an owner is a proprietary approach and the idea that he is a mere investor is an entity approach.

Following the entity approach, ownership has been divided between the stockholders and creditors. Because of their passive attitude as stockholders, by not taking an active part in the annual meetings and showing little interest
in the corporation's activities, the stockholders conduct themselves more nearly like creditors. Another reason is that the stockholders have no claim to corporate income and only receive a return on their investment when dividends are declared. Hence, their position is inferior to creditors.

Following the proprietary approach, a stockholder has as much ownership as any other stockholder and collectively they own the corporation. The stockholder owns the equity in the corporate assets after all debts of the corporate enterprise are met. The stockholder receives dividends which are a distribution of corporate profits.

The sale of bonds represents a liability to the issuing corporation for a specific amount within a specific time period. The interest on the bonds must be paid or the bondholders may force the corporation into receivership. Dividends on the other hand do not have to be declared and the stockholder cannot force the corporation to declare dividends whereas the bondholders can force payment of interest.

The general creditors of a corporation can look to just the assets for payment of debts whereas the creditors of a partnership or sole proprietorship can look to all the individuals' free assets.
The stockholders elect a board of directors who appoint the officers. It is the right of the stockholders to elect this board and not the creditors or other interested parties. Once management has taken the reins of the corporation, they perform the managerial function for the stockholders.

Some corporations have set up plans whereby employees can purchase corporate stock. The reasons are numerous for such a program. Where corporations go so far as to guarantee the purchase price to the employee, the employee is not only a stockholder but a creditor for any losses suffered.

The distribution of dividends has been considered in two different lights, one as a distribution of corporate profits and the other as an expense to the corporation. Although there is no right inherent in capital stock which requires that dividends be paid, the entity approach considers the dividends as an expense when they are paid. The proprietary theory considers dividends a distribution of profits.

Under common law, the right to vote in a corporation was not inherent in the capital stock but the right was given to the stockholder. Thus, it made no difference how many shares of stock you owned, you just had one vote. Today, however, the right to vote is attached to the shares of stock and not to the stockholders.
Laws are passed to govern corporations directly and these laws have no effect upon the stockholders. The stockholder and the corporation are considered separate entities.

The corporation receives funds from stockholders and creditors in order to operate. Although the stockholders and the creditors continually change, the corporate enterprise remains in existence.
CHAPTER V

MANAGEMENT VIEWPOINT

OF THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

The importance of management in the whole network of corporate enterprise is unquestioned. The officers who govern the corporation and guide it through all of its ills and good fortune are in the center of the whole problem of the entity and the proprietary theories.

With the growth of industry and business, ownership became less and less important, with the management group actually gaining in importance. It is impossible for the large corporations with hundreds of stockholders to have the stockholders play an active part in the administration of corporate business. Hence, more and more of the usual duties of the owners are being taken over by the management element of the corporation. With the divorce of ownership and control, it is only logical that management should exercise the control necessary to operate the corporate enterprise which was formally in the hands of a few stockholders.

One of the ways in which management has been able to retain control in the large corporate enterprises is
through the use of the proxy machinery. Since ownership in the large corporations is so widespread, management has been able to control a corporate enterprise without an appreciable amount of stock in its actual possession.\(^1\) As long as the present management acts in favor of the majority of stockholders, there is usually no one individual or small group of individuals who can gain control of the corporate enterprise and thus, replace the present management. The stockholders will usually go along with the present management unless and until the time they become dissatisfied.

Management's increase in power can be directly attributed to the growth of the corporation.\(^2\) As the corporate enterprise grew in financial and physical resources, there was a need for professional men to operate the enterprise. The wealthy were not able to contribute all of the necessary capital nor were they able to operate the large specialized corporations efficiently. Thus, professional management groups began to spring up and operate the corporations and funds began to flow into the corporate enterprises from small investors as well. In order to operate

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\(^1\) Encyclopaedia of the Social Sciences (New York: The Macmillan Company, 1937), III, p. 419.

\(^2\) Ibid., p. 418.
these large corporations, the management groups needed sufficient authority and they received it. Hence, this new power of management gives strength to the entity theory in the present corporate enterprise system.

The development of the corporate system as it exists today with regard to the large corporations is quite similar to the development of the democratic form of government in this country. When the country first received its start, the government was by direct rule and in the form of town council meetings. As time progressed, and the country began to spread in territory and increase in population, it became necessary to form a centralized government. The people in the districts would elect their representatives who would represent the voters in Washington. When there were but a few voters, one vote meant a great deal but with the increase in population and hence, the number of voters, the power of one vote or even many votes became less and less important. This same situation exists in the corporate enterprise system today. The stockholder, as such, with one vote in a large corporation is not too important from a total organization point of view but he is an essential contributor to the whole picture of corporate enterprise theory. The evolution of the system of government is similar to the proprietary and entity theories of corporate enterprise. The proprietary theory resembles the government
when it was young, and the government in its present status resembles the entity theory.

The term management has been defined in many different ways with a number of different connotations. Berle and Means define management "... as that body of men who, in law, have formally assumed the duties of exercising domination over the corporate business and assets."\(^3\) Usually, the contributors of equity capital to the corporate enterprise before 1900 were the operators of the business. There was no dispute over control of a corporation and the ownership of a corporate enterprise "... as so frequently happens today."\(^4\) The idea of capitalism and the corporation which existed before 1900 served the proprietary theory. The corporate enterprise was an organization of the stockholders and they not only played an important part in the operations of the corporation but they also controlled it. However, today there is less certainty among the stockholders as to who can exercise authority or control. Hence, the management group has taken over the reins and now the entity theory is present.


Following are some of the comments made by different authors in management with respect to the ownership of the corporate enterprise. As can be seen, the comments vary widely when considering the entity theory, the proprietary theory, the stockholder, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete entity theory and the proprietary theory of corporate enterprise will be presented in the eighth chapter.

**Stockholders.** The stockholder very seldom takes an active part in the management of the corporate enterprise. In a small concern, the owners are usually the managers but as the firm begins to grow and the number of stockholders increases, the stockholders individually take a less and less active part. The only active part that a stockholder usually takes in the corporate enterprise is when the stockholder is elected to the board of directors or is an officer of the corporation. There are cases where employees purchase capital stock of a corporation and thus play an active part in the operations of the corporate enterprise but this activity is usually not on the management level. It is not necessary for the stockholder to take an active part in the management of the business affairs because he can delegate the authority to the directors of the corporation who in
turn delegate authority to the officers of the corporate enterprise.\(^5\) Thus, the lack of interest on the stockholder's part follows the entity theory.

When voting rights of one class of stock are equal to the voting rights of another class of stock, this does not mean that both classes of stock are the same.\(^6\) For instance, if one class of capital stock has equal voting rights with another class but the first class of stock has preference as to income and assets—preferred capital stock—there is no division of control but the difference is in the risk. Hence, the voting rights may be the same but the ownership rights represented by each class of stock may be different in other respects.

In a corporation, the preferred stockholders' position is between the common stockholders and the bondholders.\(^7\) The preferred stockholder is an owner of the corporate enterprise but he usually receives a stated rate of return, and preferred stock is spoken of as 6% preferred stock—the 6% being used as an example. Thus, a $100 par value 6% preferred

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\(^7\) The preferred stockholder is willing to receive less income in order to receive more protection for his investment.
stock will return a dividend each year of 6 to its owner if dividends are declared. This return is a dividend and not an interest payment by the corporate enterprise to the preferred stockholders and it is not an expense of the corporation as the interest payments on the corporate bonds are. Therefore, if the corporation should pass the payment of the preferred stock dividends, the preferred stockholders could not force the corporate enterprise into bankruptcy as the bondholders could do if the interest payments on the bonds were passed.  

When a corporation has common stock, preferred stock, and bonds, the management is usually selected by the common stockholders. Even when voting rights are given to the above three classes of capital contributors, the common stockholders' votes usually outnumber the other security owners and hence, the common stockholders control the board of directors of the corporate enterprise. When there are several types or classes of common stock which have no voting rights, there must be one class of common that has the right to vote. The usual designation for several classes of common stock is A and B and C capital stock. Thus, in

9 Ibid., p. 339.
cases where voting rights are given to the creditors, and as a result, a voice in the management, the entity theory is invoked without question.

In the corporate enterprise there is frequently a dual situation with a large number of stockholders owning a small number of shares on the one hand and a few stockholders owning a large number of shares on the other. Thus, there is a concentration of corporate ownership in the hands of "... small groups of large stockholders."10

As long as the officers are carrying out their duties according to the charter and the by-laws of the corporate enterprise, the stockholders cannot interfere.11 However, if the officers are performing acts which infringe upon the rights of the stockholders, the stockholder has recourse against the officers. Thus, if a stockholder does not like the way in which the corporation is being managed, he cannot go to court unless his rights as an owner are being violated. This is another point in favor of the entity theory because the stockholder is only a small part of the whole corporate structure.


If the stockholder does not agree with the policies of management and he has no recourse in the courts, he always possesses the right to sell his shares of capital stock in the corporate enterprise and hence, he will no longer be an owner but will transfer his rights in the corporation to another party. Such action marks the continuity of the corporation and as a result, fosters the entity theory of corporate enterprise.

Because a stockholder purchases a share of voting capital stock, he is entitled to a vote for every share he owns in the corporation according to the law. Until he sells his capital stock or all of the stockholders of the corporate enterprise relinquish their voting rights together, the stockholders can participate in the corporate annual meetings. Hence, from a legal point of view, the voting stockholders are in control of the corporate enterprise by virtue of their power to vote.

Allen once said that the stockholder's stock in a corporation

... does not in the great majority of cases represent to him a part ownership and control of the mighty enterprise; it represents a way of getting some income (or profits), his right to which is attested by a prettily decorated sheet of paper which he keeps in his safedeposit box; and his interest in the corporation's fate is likely to take principally

12 Ibid., p. 222.
the form of looking at the stock-market page from time to time to see how the price is doing. If he doesn't like what he sees, he sells.\textsuperscript{13}

The old idea that the minority stockholder is not important has passed and today, the managements are giving full information to the stockholders of the corporate enterprise, Allen\textsuperscript{14} points out. Annual reports are published which give extensive data about the corporation's past, present, and future plans. This sort of information was almost non-existent in the years past. "The stockholder is viewed very much as the customer is viewed: not as an owner but as someone who had better be wooed lest he take his patronage elsewhere."\textsuperscript{15}

Although the stockholders must make the final decisions as to some actions of the corporate enterprise, the "\ldots annual meeting is ordinarily a farce."\textsuperscript{16} It is the duty of the stockholder to vote and maintain an interest in corporate affairs under the proprietary theory. However, as a mere investor, the stockholder is only interested in the return on his securities which fosters the entity idea of corporate enterprise.

\begin{itemize}
\item \textsuperscript{13} Allen, \textit{op. cit.}, p. 236.
\item \textsuperscript{14} Ibid., pp. 236-237.
\item \textsuperscript{15} Loc. cit.
\item \textsuperscript{16} Ibid., p. 236.
\end{itemize}
Some hold that even though the traditional idea of corporate enterprise is that the stockholders own and control the corporations, this idea holds true only in the small and usually young corporations which need capital today. As to the older and larger corporate enterprises, "... the stockholders are no longer in control in any real sense: they are subordinate in authority and importance to the management." ¹⁷

**Creditors.** There is a fundamental difference between the bondholders of a corporation and its stockholders. The bondholders are creditors of the corporate enterprise and the stockholders are the owners. The bondholders have all of the rights to which a creditor is entitled under the law and the stockholder is entitled to all of the privileges of an owner. Even though both bondholders and stockholders provide capital to the corporate enterprise, Froman ¹⁸ states, their respective positions differ if for no other reason than risk. In rights of claim against the corporation, the bondholders take their place along with all the other creditors and receive their share before the stockholders. The stockholders as owners receive what is left if anything.


The concern of the bondholders is quite limited in the corporate enterprise and as long as the interest on the bonds is paid by the corporation, the bondholders never take an active part in the operations of the corporate enterprise.

The holders of corporate bonds have all the rights of creditors unless limited and these limitations "... usually appear or are referred to on the bond certificate." The stockholders are not creditors because they are owners of capital stock but they may become creditors when dividends are declared but not yet paid.

The creditors of a corporate enterprise take no direct part in the management of corporate affairs. The position of the creditor gives a right to first claim for payment of debts but it does not provide for the exercising of control in the business of the corporation. Also, there are degrees of priority which may exist among the creditors. There are cases where creditors have been extremely influential in corporate matters but this is the exception rather than the rule. The right to operate the corporation belongs to the stockholders and not to the creditors even though the stockholders and the creditors both supply the capital in

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20 Froman, op. cit., p. 399.
one form or another.

The capital stockholders' claims are "... represented by the value of those assets which remain after the claims of the creditors have been met. In other words, assets minus claims of the creditors equal claims of owners, or net worth." Thus, stockholders' claims are residual in nature. The rights in the corporate assets are first to the creditors and then to the stockholders. Such a statement seems to follow the proprietary theory and uses the formula so often used to express the proprietary theory of corporate enterprise, $A - L = C$.

Management. The chief executive or president in a number of large corporate enterprises usually is a most influential person. It is often said that the board of directors chooses the president, and yet, in some corporations, the president picks the board of directors. "Such companies are frequently spoken of as being 'management controlled.'" If such be the case, there is little difference between a sole proprietor and this president in regard to control because the president has all the power. There is, however, a big difference between owner and president for

21 Ibid., p. 399.
the president could pay himself a large salary only if the stockholders did not protest. Such a case would usually exist only if the president was operating the corporate enterprise efficiently and dividends were being paid to the stockholders. However, the president does not suffer the losses which may accrue to the owners which the sole proprietor does suffer. The owner will suffer the loss of all his capital whereas the president will suffer the loss of only his salary and position.

As a governor governs a state or a president rules a country, management operates a corporation. The management of a corporation supervises the corporation’s activity, Cahn states, and protects the interests of the stockholders, vendors or suppliers, customers, and employees. If the vendors are to do business with the company, they must accept the contracts of the corporation, customers must accept the offerings of the corporate enterprise, the employees of the corporation must accept the wage contracts of the corporate enterprise, if these interested parties wish to deal with the corporation. Thus, whenever anyone

23 Cahn, op. cit., p. 220.
24 Ibid., pp. 222-223.
25 Ibid., pp. 223-224.
26 Ibid., pp. 224-226.
does business with the corporation, they must accept the
offer of the corporation or there will be no business trans­
acted. The stockholders are treated as other interested
parties of the corporate enterprise as well, for if the
stockholder does not like the procedure, he can sell his
interest in the corporate entity. Hence, the complete divi-
sion of the entity from all interested parties is accomplished
and thus, the entity theory of corporate enterprise.

Although the boards of directors are considered as
the overseers of the corporate enterprise, "... their
contribution to the actual running of the corporation tends
to be somewhat negative, if only because few of them are
living from day to day with the problems laid before them."^27
The actual influence in the corporate enterprise is usually
in the hands of the officers although at times, there are
directors who play an important part in the operations of the
corporation.

Another author has the opposite opinion with respect
to the powers of the board of directors for he says, "... for, practically all purposes, the board of directors is
supreme."^28 However, even though the board of directors
may have supreme power, the analysis can be extended one

^27 Allen, op. cit., p. 235.
^28 Cahn, op. cit., p. 228.
step further. The control or power can be divided between two officials, the chairman of the board of directors and the president of the corporate enterprise. At times, the control lies in the hands of the chairman of the board and at other times the power rests with the president of the corporation. Each corporate enterprise is different and an examination of the facts is necessary to determine just who exercises control of the corporation. Whether it be the president or the chairman of the board it is still management who would exercise supreme power here.

It is possible for a corporate enterprise to borrow money in many ways and it is usually up to the board of directors to determine the superior method. The officials can provide funds for the corporation without floating a new bond issue or requesting new stockholder's capital. Management sometimes is able to maintain good short-term sources of capital by credit from suppliers, short-term loans, and through payroll intervals. During the periods that these debts are outstanding, management is able to use this cash for other purposes. The officers can extend the credit potentials of the corporate enterprise and they do

29 Ibid., p. 230.

not have to request capital from the stockholders. Hence, when considering the obtaining of capital, the corporation can exist without the intervention of the stockholders and the divorce of ownership and control further exemplifies the entity theory of corporate enterprise.

Employees. Since one of management's leading problems today is labor, this problem becomes the concern of corporate enterprise theory. Part of the answer is in many of the new developments of the whole employee picture.

There are corporations which have a profit sharing program in their organization. "As an educational program Profit Sharing helps workers understand the necessary role and function of capital supplied by others, instead of leading them to believe that they can supplant that contribution by assuming the dual role of worker-owner."31 Under the profit sharing method of distributing extra wages or bonuses, the employee does not become an owner because he shares in the profits of the corporate enterprise. There are many other factors which must be considered before a person can be considered an owner.

The idea of employee ownership of capital stock in the corporation in which he is employed is favored because

it is intended to give the employee a feeling of belonging. "Although often advanced as a means of bringing control of companies to the workers, the ownership of a majority of stock has seldom been realized." The usual practice is to sell to employees a nonvoting type stock or limit the amount of stock the employees can buy through the company. There are employee stock purchase plans which call for the redemption of the corporate stock at a stated price when the employee leaves the corporate enterprise so that the employee is guaranteed the purchase price of his corporate investment and thus, he will not feel cheated.

**Government.** An interesting point about corporate theory in regard to actions which the corporate enterprise may perform is that natural persons can do anything which is not prohibited by law whereas the corporation can perform only those acts which are permitted by the corporate charter. "It follows that a corporation may enter into such contracts in such manner as it is permitted by its creator, the government."\(^{33}\)

There are two important considerations when dealing with corporate theory. The law of the land determines the

\(^{32}\) Ibid., p. 167.

\(^{33}\) Marshall, op. cit., p. 436. This follows the entity idea of the government giving the corporation the power to act.
the acts of the corporate enterprise but the corporation determines the terms of the contracts. The state and federal laws determine those acts which the corporation may perform and the corporate enterprise can only perform those acts which the government expressly permits. Citizens, on the other hand, can perform any acts that are not expressly prohibited by law. In making contracts, the corporation acts as any other individual and sets the terms of the contract. However, the terms and nature of the contracts must be in accord with the rights to contract given the corporation by the laws of the land and the corporate charter. Many variations of the contracts are possible and these variations usually reflect the policies of the business unit.

**Miscellaneous.** Although the stockholders are the owners of the corporate enterprise, Cahn states, they become the governed after the board of directors has been elected. This situation is similar to the national government because after the representatives are elected to congress, congress governs the people whom they represent and who have elected them.

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34 Marshall, *loc. cit.*

In large corporate enterprises, Gordon\textsuperscript{36} states, not all of the members of the board of directors are chosen by the stockholders. In most cases, the board members are elected by the stockholders but there are cases where non-stockholding groups have insisted on naming some of the directors of the corporation. Investment bankers are an example of a non-stockholding group who have at times been instrumental in placing some directors on the board of a corporate enterprise with the approval of the stockholders.

One of the simplest ways to see the difference between the corporate entity and the claimants is in the balance sheet of the corporation which is prepared by the accountant. On the left hand side of the balance sheet are found the assets of the corporation and on the right are found the creditors and owners' equity accounts. "This sort of analysis \textit{sets up the business unit as separate from its entrepreneurs}, and shows the relation between the two."\textsuperscript{37}

Thus, the entity theory of corporate enterprise is served because the entity is the whole whereas the claimants represent only a part of the whole.

\textsuperscript{36} Gordon, op. cit., p. 121.

The entity as such, Robinson relates, has an existence entirely separate from the owners and the managers. The ownership may change hands over and over again through death or sale of the corporation's stock and the management may change as well but the corporate enterprise lives on. The employees and the creditors may change continually but the corporate enterprise does not. Therefore, the corporation as such is not dependent on a particular group of stockholders, managers, creditors, or employees for its continued existence.


Twenty years ago, the writer had a controversy with the late Professor E. Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were powers in trust for stockholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention.39

Management's first obligation is to the corporate enterprise as a whole but "... management also has a responsibility: (1) to the people who work for the company;


(2) to the local and federal governments; and (3) to the customer.\textsuperscript{40} Therefore, management must persuade "... labor, government, and stockholders to allow management to do the things that will keep the customers buying,"\textsuperscript{41} if the corporate enterprise is to continue in business.

\textbf{Summary.} Management occupies one of the leading positions in corporate enterprise theory today. The professional managers have taken over the duties of managing the corporation which were formally in the hands of the stockholders. With stock ownership so widespread, some managements have been able to remain in power without any appreciable amount of stock in its actual possession.

In the small corporations, the stockholders are usually the managers. However, in the large corporations the managing groups are generally professional managers hired by the board of directors who are elected by the stockholders. The stockholders delegate to the management, authority necessary to carry on the business. As long as management carries on the duties within the limits of the authority and to the satisfaction of the stockholders, they are not replaced nor can they be forced to leave unless they are committing

\textsuperscript{40} "Management's Part in Prosperity," \textit{The Stanocolan}, XXIX (July 25, 1942), reprinted from \textit{Manage Magazine}, p. 2.

\textsuperscript{41} \textit{Loc. cit.}
illegal acts. Also, if a stockholder does not agree with the policies of management, he has no recourse, except to sell his stock, as long as management is not acting outside of its scope of authority. The idea that the stockholders, especially the numerous stockholders who own just a few shares of capital stock, are not important has passed and management is giving full information to the stockholders through extensive reports and bulletins throughout the year. There are a great number of stockholders who do not take an active part in the annual stockholders' meetings, and hence, the annual stockholders' meetings have been called a farce.

The creditor plays no direct part in the activities of the business except in rare cases where bondholders have been given the right to elect some directors. However, creditors may be extremely influential in an indirect way by suggesting changes and even requesting certain members be placed on the board of directors.

The management group has not only assumed the function of managing the corporation but also the control of the corporate enterprise. In order to perform an efficient job it is necessary in some cases for management to exercise control of the organization and hence, obtain one of the rights of an owner. Some management groups have become so strong that they have perpetuated their position. However, this is not
the usual case for unless management can produce, the stockholders will become displeased and vote the management out. The management group also decides how much income is to be distributed to the stockholders and in some cases management has not declared dividends for many years. Thus, again the stockholder is restricted, because a right of an owner is usually to determine what disposition will be made of his income.

Although employees share in the profits of a corporation, this does not mean they are owners. The employee is paid extra compensation for work performed and hence, the so called distribution of profits is none other than an increased wage expense.

Although the stockholders own the corporation, they become the governed after the board of directors are elected which is true in government. Also, even though the governing body and the governed change, the government continues in existence. The same is true of corporations because even though the stockholders, management, creditors, and employees change, the corporate entity continues to exist.
CHAPTER VI

ECONOMIC VIEWPOINT

OF THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

A study of the corporate enterprise is not complete until the economic aspects of the entity theory and the proprietary theory are covered. Economists have led to some changes in both the proprietary and entity theories.

One of the leading difficulties in the study of the corporation is terminology. The writers in economics have not helped a great deal in this matter. Davis had the following to say.

It is commonplace that economists spend a discouraging proportion of their working time in controversy over definitions. It may be less commonplace, although surely not original, that much of the difficulty arises from failure to recognize the implications of an elementary principle of taxonomy: when the point of view from which phenomena are classified is changed, alterations in both the composition and behavior of the groups observed must be expected.¹

Whenever a new meaning to a word is implied, a new word is not usually coined. However, an old word is used and it is expected that all the readers will grasp the new and expected meaning. But, this does not always happen and

as a result, there are many confused individuals as well as ideas.\textsuperscript{2}

The term assets from an economic point of view means,

all wealth, property and property rights, including claims against other persons or against their property, which belong to a person or enterprise. In a balance sheet, total assets are exactly equal to the total liabilities—i.e., to all claims against the property of a company (including surplus and undivided profits).\textsuperscript{3}

In the works of economists, businessmen, and other writers, the term capital (net capital) usually implies a source of revenue. However, the terms should have reference to "... interest of a particular proprietor in them."\textsuperscript{4}

Couchman says that capital as used in accounting can be defined "... as the excess of asset value over the liabilities of any commercial entity. It is used synonymously with the terms 'net worth,' 'proprietorship' and 'owner's equity.'"\textsuperscript{5} Here, Couchman is defining capital according to the proprietary theory, $A - L = C$.

\begin{itemize}
\item\textsuperscript{4} John B. Canning, \textit{The Economics of Accounting} (New York: The Ronald Press Company, 1929), p. 54.
\item\textsuperscript{5} Couchman, \textit{op. cit.}, p. 173.
\end{itemize}
Considering liabilities,

In accounting, the financial obligation or debts of a person or business. Proprietorship or net worth of a firm is the difference between assets and liabilities, and thus represents the residual equity of the owners of an enterprise in its assets. In the financial balance sheet, however, proprietorship or net worth is included among the liabilities as representing the claims of the owners of the enterprise against its assets.\(^6\)

Canning says that liabilities imply "... a relationship between persons. One who is obliged to do something adverse to his own interest and beneficial to another's has a liability to that other person."\(^7\) The liabilities of the corporate enterprise are between the corporation and the creditors and not between the creditors and the stockholders.

Following are some of the comments made by different authors in economics with respect to the ownership of the corporate enterprise. As can be seen, the comments vary widely when considering the entity theory, the proprietary theory, the stockholders, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete entity theory and the proprietary theory of corporate enterprise will be presented in the eighth chapter.

\(^6\) Horton, Ripley, Jr., and Schnapper, \textit{op. cit.}, p. 119.

\(^7\) Canning, \textit{op. cit.}, p. 49.
According to some economists, the corporate enterprise has been defined as a legal entity separate from its owners. This separate entity "... is established under authority of the state and is a 'legal person or being' entirely separate from the owners of its stock."^8

There have been some comments which place economic thinking in the school of the entity theory.

The industrial enterprise is an autonomous institution. It has its own law and rationale in its function. It is not a creature of the State. It does not rest its power on delegation from its stockholders or from any other owner; in fact, the divorce of control over the enterprise from ownership is everywhere all but complete. Its function is essentially beyond the control of the State and largely unaffected by even the most radical changes in political system or in political beliefs. It is the first autonomous local institution that has come into existence in our society in five hundred years.9

The inference here is that the corporate enterprise is a complete and separate entity.

A definition for proprietor is a "... holder of assets."^10 Proprietorship would be all of the "... beneficial interest of a holder of a set of assets in those assets."11 In order to determine the net proprietorship,

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10 Canning, op. cit., p. 48.
11 Ibid., p. 55.
the liabilities would be deducted from the total proprietorship or Assets minus Liabilities equal Net Proprietorship.\textsuperscript{12}

"Proprietorship is synonymous with ownership."\textsuperscript{13} Ownership represents a residual equity in the corporate assets and the owners would suffer the losses or reap the gains. Primarily then, the owner undertakes the greatest risk in the corporate enterprise.

The term entrepreneur has caused much discussion in the field of economics. Some economists hold that the entrepreneur is the person (or persons) in control of the corporate enterprise, others claim the entrepreneur is the owner of the corporate enterprise, and still others hold that the entrepreneur is a combination of both ownership and control. Enke held that,

The entrepreneurial function is then conceived as including all productive contributions that are not routine human effort, do not involve the use of indestructible natural resources, and do not entail the provision of capital funds. Entrepreneurship according to this view is a residual function, just as profits are often described as residual income.\textsuperscript{14}

\textsuperscript{12} Ibid., p. 56.


Another author brings out the idea of control and risk-bearing as a mark of entrepreneurship and the combination of the two is "... usually attributed to the ownership of a going business."\(^{15}\)

The corporate enterprise is not necessarily a form of economic organization. The corporation may satisfy the organization needs of a large-scale or small-scale business. The purpose for the union of individuals is to keep their own interests apart from the corporate enterprise. "Nevertheless, the legal institution of incorporation has had important economic consequence."\(^{16}\)

The concept of the economic man was developed by the Classical School of economics as "... an individual whose actions are solely motivated by economic self-interest or the desire to maximize his economic gain with the least possible effort."\(^{17}\) This economic man may be a human or an artificial person.\(^{18}\)


\(^{17}\) Byrne J. Horton, Julien Ripley, Jr., and M. B. Schnapper, op. cit., p. 106.

\(^{18}\) Ralph H. Blodgett, Comparative Economic Systems (New York: The Macmillan Company, 1944), p. 35. "... most corporations, as artificial persons or impersonal beings,
The concept of corporate enterprise is not economic but legal. Since this corporation is a legal concept created by the state and given certain rights by the state, the law has stipulated that the corporate enterprise is separate from the stockholders and the other interested parties.

Considering the proprietary theory and the corporation, Haney made the following comments.

There may be little harm and much truth in regarding corporations as legal persons in the sense that a relationship among individuals has been endowed with endurance and given a name. But one must regard the personality, so-called, as derived. It is not fundamental nor causal; ... It is sound, rational procedure, then, to begin at the beginning and to grasp the concept of unity-through-association--of the river through the drops and the forest through the trees.

Stockholders. The corporate enterprise can be financed by two types of securities, capital stock and bonds. The capital stock of a corporation represents ownership and the bonds represent loans to the corporate enterprise. The rights pursue profits with greater if not utter abandon. In their neverending search for economic gains, they approximate, as closely as anything can in modern life, the classical concept of the 'economic man.'

19 Boulding, op. cit., p. 400.

of the security holders may vary according to the following three classifications.

(1) the right to an early claim on the income;
(2) the right to the 'residual' income, however, large, after others have been paid promised amounts; and
(3) the right to vote on the personnel and policy in the corporation, and hence the power to control the corporation.21

CAPITAL STOCK
1. Represents an owner's equity having no maturity date.
2. Represents a residual claim on assets.
3. Is entitled to share in all net earnings; automatically obtains full title to any net income; distributions are called dividends.
4. Has full rights of control in corpus.

FIXED LIABILITIES (BONDS)
1. Represents a loan having a fixed maturity date.
2. Represents a prior claim on assets.
3. Are entitled to a fixed annual return called interest.
4. Have no rights to control corpus earnings except in case of default.22

In making the bridge between capital stocks and bonds, Fisher23 compares the closeness of preferred stocks and revenue bonds. All elements of corporate securities involve risk but the degree of risk which each security (of the same corporation) carries is the important factor. The common

22 Robinson, Adams, and Dillin, op. cit., p. 141.
stockholder, as an owner, has the greatest risk and the secured bondholder has the least amount of risk. Between the two, the preferred stockholder is an owner but does not have the same amount of risk as the common stockholder because his position is preferred and above the common stockholder. Above the preferred stockholder is the income bondholder who has less risk than the preferred stockholder but more risk than the secured bondholder. Thus, it can be considered that the preferred stockholder and the income bondholder have about the same amount of risk as to income with any edge going to the bondholder. One difference between these two securities lies in the fact that the preferred stockholder may have voting rights whereas the bondholder will receive voting rights only in case of default and the bondholders will receive their capital contribution on a certain date when the bonds are redeemed whereas the preferred stockholder is not paid his capital contribution until the business is liquidated or the preferred stock is retired.24

24 The fundamental difference between the preferred stock and income bonds is a creditor-ownership relation.

It can be further stated that the bondholder has the least amount of risk with the smallest return and virtually
no control; the preferred stockholder has a greater return with increased risk and he may have some control; the common stockholder has the greatest risk with the possibility of the highest returns and in most cases, he has complete voting power.  

In most of the large corporate enterprises today, there are virtually no cases where a single person or small group of persons own a majority of the capital stock outstanding which would give positive voting control. Most of the ownership is spread over thousands of shareholders. After an individual invests in a corporate enterprise, there is usually little he can do if he is a bondholder with respect to control of the business activities. However, if he concentrates his wealth by purchasing capital stock in the corporation, and his capital stock holdings become substantial, he can usually exercise some voice in the business activities even though he does not own a controlling interest as such.

As corporate enterprises became larger and the economy


became more complex, the stockholder became less and less active in corporate affairs. Today, Ise states, the stockholder "... has become a mere passive agent with no management functions, no control, and no responsibility."28

The stockholder hopes that his investment in the corporation will return him a satisfactory income but the actual managing of the business affairs is usually left to a small group of insiders.29 Usually, the stockholder does not consider himself as the owner of the corporate enterprise but his interest lies only in the dividends he receives and the market value of his stock, especially, if he intends to sell.30

Usually, when a person owns a thing, he controls it. However, even though a stockholder may own shares of capital stock in a corporate enterprise which is evidence of his pro rata ownership, he does not necessarily control the corporation. With the diversification of ownership in corporations today, less than a majority of voting capital stock could conceivably control a corporate enterprise.31

28 Ise, op. cit., p. 102.


From a theoretical point of view the control of a corporate enterprise rests with all of the stockholders who own voting stock since it is the vote of the stockholders collectively which governs. With the divorce of ownership and control, the stockholders elect a board of directors whose duty is to operate the corporate enterprise for the stockholders.\textsuperscript{32}

When stockholders elect directors, the majority of stockholders, in most cases, know little if anything about the directors. The main interest of the stockholders is that the directors carry on the business of the corporation in such a way that dividends will be declared. Hence, it has been said that "... the assumption of stockholder control is largely moonshine."\textsuperscript{33}

The corporate enterprise has two major divisions as Clay points out. The organization is important because "... in it the ownership and the employment of capital are separated; secondly, the work of organization is separated from the bearing of risk, the former being done by specialized workmen for regular salaries, while the latter is undertaken by the stockholders to whom the profits go."\textsuperscript{34}

\textsuperscript{32} Ise, op. cit., p. 87.

\textsuperscript{33} Ibid., p. 88.

\textsuperscript{34} Henry Clay, Economics (New York: The Macmillan Company, 1926), pp. 56-57.
Most people are under the impression that stockholders' meetings are enormous affairs. However, this is not usually so and in most cases, only a few people attend the meetings. It is this small group of stockholders in attendance who usually dominate the corporation and who some claim are really the true entrepreneurs.35

The stockholder must have some rights in a corporate enterprise in order to base his claim of ownership. Hence, the stockholder has property rights and furnishes only "property services"36 to the corporation and usually no labor. The property rights of all the stockholders grouped together are called capital stock. The capital stock in turn represents the property rights of the stockholder in the corporation.37 These property rights of the stockholders in the corporate enterprise represent a beneficial interest in all of the corporate assets, and all gains which accrue to the corporate enterprise because of the use of the assets.38

When a corporation owns stocks and bonds of another corporation, the stocks and bonds of the second corporate enterprise are assets of the first corporation. To the second corporate enterprise these stocks and bonds represent capital contributions and liabilities. If a complete entity view is taken, the stocks and bonds of the second corporation are liabilities and represent the claims of the stockholders and bondholders to the corporate assets of the second business only.39

The stockholder in a corporate enterprise is a bearer of risk. The risk arises because of business conditions and the uncertainty of any returns on the stockholder's investment. The bondholders and the other creditors, on the other hand, have some risk but they receive payment first and the amount of return is known. The bondholders and creditors usually receive their returns which are guaranteed by the assets of the corporate enterprise and the capital contributions of the stockholders.40

The stockholder is usually investing in the long run possibilities of a corporate enterprise when he purchases capital stock. Although there is no guarantee on future


earnings of the corporation, the stockholder has some expectations for the long run which are not usually required for other types of securities.\textsuperscript{41} 

The stockholder receives dividends on his investment in the corporate enterprise but all of the profits are not always distributed to the stockholders and are not payment for capital contributions. Since bonds do not carry a great amount of risk, the return is deemed an interest charge by the corporate enterprise but the common and preferred stockholders have too much risk at stake to receive just interest on their investment. The stockholder's return is a distribution of existing profits and as such is payment for performing the entrepreneurial function.\textsuperscript{42} However, all of the profits are not distributed to the stockholders, and a part of the undistributed income or profits earned belongs to the corporate enterprise.\textsuperscript{43}

The purpose of the corporation is to earn income for its investors.\textsuperscript{44} The income that is earned by the corporate


\textsuperscript{42} Enke, \textit{op. cit.}, p. 455.

\textsuperscript{43} Commons, \textit{op. cit.}, p. 162.

\textsuperscript{44} Maurice Moonitz, "The Valuation of Business Capital: An Accounting Analysis," \textit{The American Economic Review}, XL\textit{I} (1951), 158.
enterprise can be divided into two parts. The first is a return on the capital invested and the second is a return for the entrepreneurial function.\textsuperscript{45}

The stockholder of a corporate enterprise is an owner but his ownership is not the same as the owner of a proprietor0x00x00x0 proprietorship or partnership. The stockholder does not even own the assets of the corporation but the stockholder shares in the equities which result after the debts of the corporate enterprise are subtracted from the assets.\textsuperscript{46} The ownership of the stockholder in large corporations is more capitalistic\textsuperscript{47} than operating ownership. The stockholder usually delegates authority to others who operate corporate enterprises and protect the stockholder's interest. For the small corporation, there may be no need to incorporate and hence, the corporate form of business organization may be only a legal fiction.

\emph{Creditors.} The stockholder and bondholder have two separate positions in the corporate enterprise. The stockholder is the owner of the corporation and the bondholder

\textsuperscript{45} Sergei P. Dobrovolsky, "Corporate Retained Earnings and Cyclical Fluctuations," \textit{The American Economic Review, XXXV} (1945), 571.

\textsuperscript{46} Mitchell and others, \textit{op. cit.}, p. 92.

is a creditor of the corporate enterprise. In case of default on the interest of the bonds, the bondholder may become the owner of the corporation in a reorganization by exchanging the defaulted bonds for capital stock of the reorganized corporation. Or, the bondholder may force the corporate enterprise to liquidate if the interest payments are passed. Hence, the position of the bondholder is somewhat financially stronger than the position of the stockholder.

From an economic point of view, the bondholder is a lender of funds to the corporate enterprise and all claims of the bondholder are against the corporation and not against the stockholder. The corporate enterprise has an obligation to pay the interest and principal of the bonds to the bondholders.

When speaking of preferred stockholders as creditors rather than as proprietors, Paton says, "... there is some justification for viewing them as 'inferior creditors' rather than as providers of risk capital."^49

Some of the confusion in considering stockholders as creditors is in the use of terms. Schumpeter, in describing stockholders, says, "... they are creditors

^48 Ise, op. cit., p. 84.

^49 Paton, op. cit., p. 219.
(capitalists) who forego part of the legal protection usually extended to creditors, in exchange for the right to participate in profits." Creditors do not participate in the profits of the corporate enterprise but the stockholders do. Here, the term creditor is being used to refer to all claimants against the corporate enterprise.

The concept of owners and creditors is difficult to understand. Here are two groups who lay claim to the same assets of the corporate enterprise. The difficulty seems to ease slightly when the rights of the two groups are considered separately. The creditors have prior claim to the assets of the corporate enterprise and the owners have a residual interest in the assets.

There has been much development along the lines of creditor stock ownership. By having the creditors of a corporate enterprise invest in the corporation, there is usually less tendency to force payment of bills when a little extra time is needed. Such a condition can help a corporate enterprise over a poor period and hence, in the long run, make for greater returns to the owners of the corporation.


51 Bowman and Bach, op. cit., p. 74.
The position of the creditors in a corporate enterprise is strong because they are protected by the law. Whenever a corporate enterprise is in danger and cannot meet its obligations, "... the law frequently provides for the transfer of control of the assets and sometimes the assets themselves to a receiver chosen by law or to the creditors."  

In mutual insurance companies, the stockholders are also the creditors. The owners assume all the risk of the company and divide the profits. There are usually "... almost no outside creditors."  

Management. The entrepreneur of old was the operator and the owner of the corporate enterprise. However, the idea of the entrepreneur (an entity approach) has taken on new light and "... the entrepreneur may, but need not, be the person who furnishes the capital. ... It is leadership rather than ownership that matters."  

The corporate enterprise is a collection of many units, "... land, building, plant and equipment, workers, workers, workers."  

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52 Robinson, Adams, and Dillin, op. cit., pp. 138-139.  
54 Marshall, Readings in Industrial Society, p. 714.  
55 Schumpeter, op. cit., p. 103.
materials, and so on—controlled by an entrepreneur."  

It is the duty of the entrepreneur to set all of the units in motion so that a smooth organization exists in order to make a profit.

The business unit or corporate enterprise is the important factor and regardless of who makes the decision, it is the corporation which gains or looses. The reasoning is in line with the entity theory because it places the entity as such above all others.

Although the stockholder undertakes the greatest risk in the corporate enterprise, it is the management group which chiefly controls the organization. This management group or controlling group usually owns only a small number of the total shares of capital stock outstanding of the corporate enterprise.

Boulding brings out the idea that the corporation is not only a legal entity but psychic as well in the eyes of management. Management tries to enlarge the corporate enterprise for the sake of the corporation itself and hence,


the results benefit the stockholders and all of the interested parties as well.\textsuperscript{59}

From a purely technical point of view, the stockholders do control the corporate enterprise through the board of directors whom the stockholders elect. The board of directors in turn appoints the officers of the corporation and the directors also set down the policies which the corporate enterprise is to follow.\textsuperscript{60} Hence, from a purely technical point of view, the proprietary theory of corporate enterprise is fostered here.

The divorce of ownership and control has served a great purpose to the corporation and society. Before the separation took place, the owner as the manager worked for one purpose and the purpose was his own interest. With the separation of ownership and control, the purpose of the corporation was not just for the benefit of the stockholders but for the consumers, workers, creditors, and society in general. Here, the corporate enterprise is considered a combination of interests.\textsuperscript{61}

Because a person makes decisions in regard to a corporate enterprise's actions, the decision making does

\textsuperscript{59} Boulding, \textit{op. cit.}, pp. 782-783.

\textsuperscript{60} Froman, \textit{op. cit.}, p. 35.

\textsuperscript{61} Drucker, \textit{op. cit.}, p. 35.
not mean he should be the owner of the corporation. In fact, he is usually not the owner but a member of the management group. The old idea that owners should make all the decisions since they are the ones who may suffer the greatest loss does not hold true today. As a result of a poor decision, it is true that the stockholder may lose his entire capital contribution but the management will also suffer the loss of their positions. The risk of poor management is one of the risks encountered by the stockholders of large corporations.

The earnings of management are sometimes regarded as high in relation to the return on invested capital. The reason is because of the great mental strain "... in organizing and devising new methods; or because it involves great anxiety and risk; and these two things frequently go together."

With the divorce of control and ownership, the stockholder is no longer in control of the corporate enterprise in this country. Professional managers have taken over the duties of actually operating the corporate enterprise and although the stockholders' legal representatives are the board of directors, in some cases, the directors have taken


less and less interest in the actual operations of the corporation. In certain instances the directors are so removed that management "... considers them 'outsiders' and resents any 'interference' from them."64 Drucker treats the subject more severe here than most authors but there are cases where such situations do exist. However, it could not be considered as the general condition.

Samuelson brings up an interesting point about management control when he says, "... there is no fully effective democratic control of management by the stockholders. Political parties may go in and out of office, but most corporation managements are self-perpetuating."65 This is an extremist's viewpoint and hence, not held by most people.

Because of the control exercised by some corporate managements, there are some abuses. At times and in certain corporate enterprises some officers may draw large salaries and receive other benefits which would be considered abusive.66 However, this could not be established as a general rule but rather the exception.

The old idea that the capitalistic system has control

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64 Drucker, *op. cit.*, p. 34.
66 *Ise, op. cit.*, p. 98.
by the owners of the corporation as a characteristic does not exist today. The owners are having less and less control in the corporate enterprise and the main reason "... has been the development of the large corporation with its thousands of owners."\(^6\) Since the management owns only a small portion of the capital stock of a corporate enterprise and this portion of stock ownership is not anywhere near the fifty-one per cent necessary for positive control, you could say, "... that the same persons who own the corporations do not necessarily control them."\(^7\)

Except in corporations where there is a strong minority group of the corporate enterprise controlled by a family, the stockholder usually has little to say about how the corporation is to be operated. Such a situation does not mean that the management as such is the only group that makes decisions but the corporation's policies are usually influenced by many interested parties. The bankers, bondholders, labor, and government often play an important part in the policy setting of the corporate enterprise.\(^8\)

Paton adds that the reason management has taken such

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67 Froman, op. cit., p. 209.
68 Ibid., p. 213.
69 Ise, op. cit., p. 89.
a prominent place in the corporate enterprise is because the stockholders are negligent. Whenever there is a dispute with a corporation, it is always considered as a difficulty between the corporate management and the interested party. As Paton suggests, this difficulty is not between management and the interested party but the difficulty is between the stockholders and the interested party. The management group is just the representative of the owners and the owners are "... the ultimate authority." Paton has failed to bring out the idea that if the management group is acting within its scope of authority, stockholders are bound by the decisions of management as the country is bound by the decisions of Congress although the actions of Congress may not always be the will of the majority of the people.70

Employees. The economic position of employees in the large corporate enterprises is becoming more and more important each year. There has been a decided shift of some power in the corporation from the "... businessmen to the representatives of employees."71 With the growth

70 Paton, op. cit., p. 226.

of labor unions and the influence they possess, the employees of the corporate enterprises have advanced to a position of dignity along with the owners, managers, and creditors which gives weight to the entity theory.

**Government.** The government is now playing an important role in corporate enterprise theory. After World War II, the government became a big lender of funds to corporations through the Reconstruction Finance Corporation and in some cases, the government became the owner of large corporate enterprises. However, today, the government is lessening its interest in corporations as an owner and it is returning business to the businessmen. But, this new policy of the government may be changed in the future and the government may again become an active member of private enterprise directly. Ise has suggested that the government should not step out of the picture but should increase its interest in the corporate enterprise. One of the ways he suggests for doing this is obtaining capital stock of corporations "... from the estates of wealthy decedents under the inheritance tax, instead of requiring the payment of the tax in cash." 72

72 Ise, op. cit., pp. 105-106.
Balance sheet. Although the asset side of the balance sheet balances against the liabilities and net worth side, this does not mean that the individual items of assets correspond to the individual items of the liabilities or net worth. Usually, no two debits or credits are equal. For example, the buildings do not correspond to the notes payable, the accounts receivable do not correspond to the bonds payable and so forth. Hence, the only valid conclusion that can be drawn in comparing items of the balance sheet is that "... the creditors have a general claim against the enterprise of a definite value, and the owners have a residual claim against the rest."73

The claims of the creditors against the assets of the corporate enterprise are actual liabilities when the debts become due and are not paid. However, with the assets on the left side of the balance sheet, it is commonly conceived that the liabilities are claims against the assets before any obligation as such is present.74 The obligation of the corporate enterprise is not necessarily when the entry is made but the obligation is when the contract due date is reached. Thus, the obligation when recorded is not of a legal nature but practical.

73 Samuelson, op. cit., p. 135.
74 Canning, op. cit., p. 53.
The use of the term capital to include liabilities and owners' equity can be considered an economic concept. The total assets which are on the left-hand side of the balance sheet represent all that is owned by the corporate enterprise. The liability or claim against these assets is represented by the capital invested in the business. This capital, from an economic point of view, represents the "... funds invested in all the assets of business, dividing the capital into that owned and borrowed."75

A further point raised by the economists is that "...the economic balance sheet derives entirely from income expectations, while an accounting balance sheet can be viewed as the basic tool for computing accounting income."76

In summing up some of the various concepts held by some economists, in regard to the balance sheet, Samuelson said that the balance sheet was always in balance because "...net worth, i.e., the ownership of the 'residual claimants,' always adjusts itself to make things balance."77 All of the equities on the balance sheet of a corporate


77 Samuelson, op. cit., p. 134.
enterprise, capital and liabilities, are found as assets on the balance sheet of other corporate enterprises or individuals. And in the final analysis, "... the real ownership of all 'things' possessed by a society must be found in individual persons."\(^78\) Canning has contributed two other concepts and the first is that the corporation is merely an imaginary entity and a figure of speech. In reality, the world of statistical analysis and synthesis has no place for mere figures of speech and the corporate enterprises have no place in the world of reality but only "... have their proper place in the conceptual world of analysis in pure mathematics."\(^79\) Both Samuelson and Canning would follow the proprietary theory of corporate enterprise and would not consider the importance of the corporate entity as such.

**The going concern.** Commons, in describing the going concern concept, says the following:

The going concern is animated by a common purpose, governed by common rules of its own making, and the collective behavior in attaining that purpose we distinguish as a 'going business.' It is this collective behavior of this collective will, this flow of transactions along lines indicated by its own working rules, this going business of a going concern,


\(^{79}\) Canning, *op. cit.*, pp. 54-55.
that contributes the invisible, intangible being of Marshall's definition. It is not an artificial 'creature of law'—it exists prior to the law in the intentions and transactions of its members, and thus exists in the very nature of the human will as well as 'in contemplation of law.'

The reason the going concern continues to exist is that expectations are still present. Once the expectations drop, even though the corporate enterprise exists in the eyes of the law, the corporation will soon fail.

The going concern concept does not include just the stockholder but it comprises all the contributing factors. The will of the corporate enterprise is the composite will of all, even down to the last worker.

The working rule of the corporation is like the rules set up by the government. The government is not the people as such but the government comprises a group of working rules set up by the duly elected officials over years past to govern the future rulers of the society.

The ownership of capital stock and bonds of a corporate enterprise are not evidences of ownership of the physical property of the corporation "... but of residual shares

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80 Commons, op. cit., p. 145.
81 Loc. cit.
82 Ibid., p. 146.
83 Ibid., p. 149.
in the expected net income." The title to the physical property remains in the corporation.

The whole going concern concept, as described by Commons, is an entity approach to corporate enterprise theory because in considering the corporate enterprise Commons brings out the idea of the will of the corporation comprises all the contributing elements down to the last worker.

Miscellaneous. An excuse for the creation of a separate entity, Paton relates, is because the large corporations have many stockholders. If the stockholders took an interest in the affairs of the corporate enterprise and attended the meetings, there would be no question of proprietary theory or entity theory. Hence, Paton does follow the proprietary point of view.

The entity concept of corporate enterprise is useful in some cases but is not the complete answer. The entity is a legal concept but the laws are made ultimately for natural persons. But,

... for many legal purposes the corporation may be treated just as if it were a natural person, and

84 Ibid., p. 169. This is a strong entity approach because both the stockholder and bondholder have a residual share in the income.

85 Paton, op. cit., p. 220.
we may call it an entity if we will; but for other legal purposes the entity concept is neither useful nor relevant because it does not bring out the points at issue between the natural persons for whom, in the final analysis, the law exists. 86

It is interesting to note that some corporate enterprises have total assets which are greater than the state in which the corporation is chartered. Some of these corporations have powers granted in the charter years ago that would not be granted today. Some corporations have made contracts with countries and with foreign companies and in so doing perform acts which are above and beyond the powers of the state which granted the original charter. 87

Paton follows the proprietary concept of corporate enterprise when he insists that "... there is no such thing as a rich corporation or a poor corporation. . . . It is individuals who are rich or poor, not our institutional or physical machines." 88 Here, Paton assumes that all the wealth of the corporate enterprise is the wealth of the stockholders. But, this does not happen in reality because many large corporations have great stores of wealth which


will not be distributed to stockholders and it is not intended that the wealth will ever be distributed to the stockholders because such an action may result in liquidation.

Commons, on the other hand, would be considered as a follower of the entity concept of corporate enterprise because he held among other things that the corporation as such owns the assets and the income of the business. The board of directors have the power to dispose of the corporate income as they see fit, and in distributing dividends, the dividends must first be declared before becoming "... a liability of the concern owing to its stockholders."^{89}

**Summary.** Economists have played an important part in the development of the entity and proprietary theories of corporate enterprise. They have contributed ideas and reasons for following either theory.

Risk is one of the factors taken into account when ownership is being considered. The element of risk varies from a slight degree (wages of employees) to a great degree (common stockholders) within the same corporation (degrees of risk will vary between corporations as well). Between the common stockholders and employees are found a variety of corporate claimants with various degrees of risk.

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^{89} Commons, *op. cit.*, p. 162.
The stockholder has the greatest risks, but he also has the potential for receiving the greatest return or suffering the greatest loss. As the corporate enterprises become larger and larger, the stockholders usually take a less and less active part in corporate affairs. The stockholders elect a board of directors and the management of the business is left in its hands. The stockholders usually know little about the members of the board, but this does not concern them for the stockholders main interest is income (with the high personal tax structure, capital appreciation is also important). The stockholder usually takes a passive attitude, and as a result, the annual meetings are poorly attended with a small number of stockholders voting for the directorate. The stockholder is interested in the long run possibilities of the corporation and looks for a return on his investment. The stockholder owns the corporation, but this ownership is not the same as ownership of a partnership or a sole proprietorship, because the stockholder does not own the corporate assets whereas the partner or sole proprietor does own the assets of the business. The stockholder receives dividends for his entrepreneurial function.

Some authors claim there is almost no difference between bondholders and stockholders. However, the bondholders have a claim for a specific amount to be paid within a certain
time period whereas the stockholders have no such claim. The corporation has an obligation to pay the interest due bondholders but there is no obligation on the corporate enterprise to pay dividends. The claims of the creditors are prior whereas stockholders' claims are residual. The position of creditors is much stronger than stockholders in the corporation because laws have been passed to protect creditors and in cases, the creditors may take over control or even possession of the corporate assets.

The entrepreneur of old was the manager and owner of the corporate enterprise. However, with the increase in physical and financial size as well as the complexity of the business, it was necessary to delegate authority to directors who appointed professional managers. Hence, management took over the physical control of the corporate assets which was one of the functions of the owners. Theoretically, stockholders control the business because they can remove the present management but practically, the individual stockholder has little to say. The usual situation is for another management group to take over the control and operation of the corporate enterprise. There are some professional managers who have obtained and thus, exercised extensive power which is, however, the exception rather than the rule. One of the reasons given for management obtaining so much power is because of the negligence on the part of
the stockholders.

When dealing with the balance sheet, the total claims against the corporation are considered liabilities. Some economists, however, divide liabilities into claims of creditors and owners' equity. The total claims against the corporation represent the total capital investment in the corporate assets.

The going concern concept depends on expectations and the composite will of all the interested parties. The ownership of capital stock and bonds is not evidence of physical property but of residual shares in expected income. The corporation has title to the physical assets.
CHAPTER VII

ACCOUNTING TREATMENT

OF THE PROPRIETARY THEORY AND THE ENTITY THEORY

OF CORPORATE ENTERPRISE

One of the purposes of accounting is to supply the corporate enterprise with the necessary information to carry on the business. Accounting supplies most of the financial statements and records of the corporate enterprise. Thus, accounting procedures must be adapted to the business and the business conditions of the enterprise whenever possible and not the business enterprise adapt itself to accounting procedures. ¹

Although it is often thought that the corporate form of organization exists only for large business, the corporate form of organization is adaptable to small business as well. The same is true of accounting because record keeping and the preparation of financial statements are not limited to the complex and gigantic corporate enterprise but accounting is also adapted to the small variety store

Some people are under the mistaken impression that accounting is perfected. Because the accountant presents statements with amounts expressed in numerical figures, this does not usually mean that the accounts are absolutely correct, but it does mean that the amounts are the most meaningful under the existing circumstances. Accounting is continually developing new techniques, methods, and ideas, in order to improve business records and to present the best possible statements for the corporate enterprise.

Some say that accounts are only money records and accountability is the real basis for financial reporting. MacNeal says that "The function of accounting is to record, collate, and present economic truths." Broad remarks that, "Accounting is a branch of the science of economics and represents an attempt to measure and show by means of

figures economic facts, transactions, and results."

Accounting is an important factor in the development of the corporate enterprise. Without accounting and the service it provides, the large modern corporate enterprise could not exist.

One of the main considerations of accounting is accounting for capital. The term capital has many connotations which result in different usages and methods of handling the capital account. In the historic days of nobles and business ventures in England, the capital account of the Lord was treated as other debts of the business venture (liabilities) even though the Lord shared in the profits of the business venture.

The term capital is sometimes substituted for the term net worth thus making no distinction between paid in capital and retained earnings. The economist generally thinks of capital as the total assets of a corporation or at least those assets derived from

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8 Scott, op. cit., p. 23.
long-term debt, capital-stock issues, and retained earnings.\footnote[11]{Rufus Wixon, "The Nature of Corporate Capital," \textit{The Journal of Accountancy}, LXXXII (1946), 214.} From a legal point of view, capital usually refers to the par or stated value of the capital stock. When there are no liabilities present, capital is equal to the assets of the corporation in the economic as well as the accounting sense.\footnote[12]{Charles E. Sprague, \textit{The Philosophy of Accounts} (Fifth Edition; New York: The Ronald Press, 1922), p. 52.}

Following are some of the comments made by different authors in accounting with respect to the ownership of the corporate enterprise. As can be seen, the comments vary widely when considering the entity theory, the proprietary theory, the stockholder, the management, the creditor, the employee, and the government. The final analysis as to the contribution of the authors to the complete entity theory and the proprietary theory of corporate enterprise will be presented in the eighth chapter.

\textbf{Stockholders--proprietary theory.} According to the doctrine of a capitalistic society, all capital is owned by the government, state or federal, by individuals, or by institutions.\footnote[13]{Charles H. Porter and Wyman P. Fiske, \textit{Accounting} (New York: Henry Holt and Company, 1935), p. 19.} Corporations need capital in order to
operate and this capital must be obtained from the government, private individuals, institutions, or combinations thereof. The capital obtained by the corporate enterprise can be secured by loans from creditors or from stockholders. If the funds are obtained on a loan basis, there arises a debtor-creditor relationship between the corporate enterprise and the creditor. However, the relationship between the stockholder and the corporation is one of residual claimant rather than debtor-creditor according to the proprietary theory.

The proprietors or stockholders as possessors of capital stock of the corporate enterprise undertake the greatest risk. If the corporation suffers any great loss, the stockholder suffers the loss and if there are any gains, the stockholder benefits by the gains. The stockholder is the last claimant to the assets of the enterprise and hence, net assets equals the proprietary account.

Being the last claimant to the assets of a corporate enterprise, the stockholder is vested with some rights in the corporation and these rights, Sprague relates, are

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16 Sprague, op. cit., p. 53.
property rights in the assets. The creditors on the other hand have no property rights because they cannot order the assets sold if no other persons' rights are being violated. The stockholders can vote to change the structure of the business organization and even force liquidation of a healthy corporate enterprise whereas the creditors have no such power and can usually act only when their rights are being violated.

Generally speaking, after the stockholders, the greatest contributor of capital to a corporate enterprise is the bondholder. Both the bondholder and the stockholder are considered investors but the bondholder is a creditor-investor and the stockholder is an owner-investor. The bondholder receives his interest for money loaned to the corporate enterprise at regular intervals regardless of how much profit is made, as long as funds are available, whereas the stockholder receives a return on his investment, dividends, only if a profit is made and the directors see fit to declare a dividend. Again, the bondholder and the

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17 This is in opposition to the theory that the rights of stockholders are in the corporation and not in the corporate assets.

18 Whenever there is a mortgage the holder of the mortgage does have some contingent property rights to the specific mortgage property. He holds a prior lien.

interest due him results in a debtor-creditor relationship whereas the stockholder is a residual claimant of the corporation except for declared dividends and then he is a creditor. 20

Although the stockholder is a residual claimant of a corporate enterprise, this does not mean that he controls the corporation. Common stock of a corporation can be divided into at least two types of stock, voting and non-voting common. The investors who purchase the non-voting common stock are considered as stockholders even though they have no voting rights. Although one thinks of control in a corporation as the majority of stock ownership, this is not the case when there is non-voting common stock. 21

Undisputed control of a corporate enterprise or legal control requires ownership of a majority of voting common stock which gives the stockholder a controlling voice in the management of the corporate enterprise. 22

Stockholders--entity theory. To understand better


the entity theory a comparison between a slave and his master, as presented by Gilman, is appropriate. Under the Roman law, which permitted slavery, the slave was considered the personal property of his master, and the slave, as personal property, could not own property, personal or real, or even carry on business in his own name but only as an appendage of the master. This was the law but in reality the slave appeared to own the property and did carry on business because the master did not wish to be identified with the business.

Since the slave, according to law, could own no property, all that came into the slave's possession belonged to the master and the slave was accountable and liable to the master for any increase in the slave's possessions, as well as the original amount he received from the master. Hence, there are two accounting procedures involved in recording the transactions, the first being to record the data at a value and secondly, to record a liability of the slave to the master. In the true sense of the word, there is no

23 In the strict sense of the word, the slave story is not exactly valid as a comparison of the corporate enterprise. However, Gilman and other authors use the comparison as an example of the entity theory which should not be construed as the reason for the development of the corporate entity theory but an aid to the understanding of the theory.


25 Ibid., p. 41.
liability as there would be to outsiders since the master would be liable for his debts incurred by his slave, but to the slave, the debt to outsiders or to the master is just as great.26

Accounting today does not deal with the human personality of a slave but with the impersonal entity of a corporate enterprise.27 The corporate enterprise, as such, is an artificial being and a legal entity which is separate and distinct from all its stockholders and creditors. This corporation has all the powers to contract business which are given the corporate enterprise by the state in its charter. This corporation has certain rights besides the right to contract business and one is the right to own property in its own name. According to tax law, the corporate enterprise is taxed separately as are individuals. The corporation is taxed on its profits before dividends and the stockholder pays taxes on the dividends received from the corporate enterprise.28

The corporation is owned by the stockholders, that is to say, the stockholders own the capital stock of the

26 Ibid., p. 46.
27 Greer, op. cit., p. 21.
corporate enterprise which represents a claim against the assets of the corporation. This fact has been stated over and over again and is read throughout the literature on corporate enterprise. However, the position of the stockholder as the owner of the corporate enterprise is a little over done. In the large corporations with hundreds of different claimants against the assets of the corporate enterprise (stockholders and creditors), there is little distinction made as to who comes first and in a healthy business, few people care who comes first as long as each receives a return. The stockholder lends his money to the corporation and he hopes for a return on his investment. However, for better accounting and financial reporting, the claimants against the assets should have a division of liabilities and net worth. Sprague\textsuperscript{29} sees no reason for including proprietorship with liabilities and Gilman\textsuperscript{30} divides liabilities to the proprietors still further into the investment account and the retained earnings account. Perhaps the strongest reason for dividing claims against the corporate enterprise into liabilities and capital is because the creditors expect to be paid the amount due them within a certain period of time whereas the capital account owners

\textsuperscript{29} Sprague, \textit{op. cit.}, p. 62.

\textsuperscript{30} Gilman, \textit{op. cit.}, p. 62.
will never receive their investment in the corporate enterprise directly from the corporation unless the corporation is liquidated.\textsuperscript{31} Some past accounting theorists held that since the corporate enterprise holds and uses the assets for all the beneficiaries of the organization,\textsuperscript{32} all claims against the assets are shown as liabilities. Hence, the business owns property and owes debts. There are cases where the stockholders of a corporate enterprise do business with the enterprise and become indebted to the corporate enterprise. On the other hand, there are times when the corporate enterprise becomes indebted to the stockholders because of private transactions.

Husband presents the following comments,

Accounting theory would probably be more realistic if it accepted as its basis the fact that the corporation is an association of flesh-and-blood persons who enjoy special privileges because they have complied with certain legal requirements.\textsuperscript{33}

Husband\textsuperscript{34} also presents the idea that some assets belong to the corporate enterprise which is represented by the


\textsuperscript{34} Ibid., p. 244.
retained earnings. These assets are given up by the corporation only when dividends are declared and paid; then, the assets, in the form of dividends, become the property of the stockholders. Since the corporate enterprise operates the business, all gains accruing to the corporation belong to the corporate enterprise. The stockholders are paid a return on their capital investment but their claims against the corporation are only for the amount of the capital contribution; the retained earnings belong to the corporate enterprise, as such.

The entity concept of corporate enterprise is not accepted by all. Some consider an organization as an entity if it is a moderate or large corporation but not for small corporate enterprises. However, if the corporation has the right to be considered an entity, whether it be large or small, it should be so considered because size alone should not be the only criterion for judging.

Creditors. The creditors of a corporate enterprise are sometimes considered as special owners of the corporation. They contribute to the corporate enterprise just as the stockholders do and together, total liabilities and owners' equity, reveal the source of corporate capital. In liquidation,

35 Gilman, op. cit., p. 53.
Bell relates, the creditors and bondholders are paid first, and then the stockholders receive the residue. Hence, from an accounting point of view and in all financial statements provided to the corporate enterprise, the creditors are represented here as claimants against the assets of the corporation.

Management. When the stockholder purchases capital stock in a corporate enterprise he is making an investment in the corporation. Evidence of this investment in the corporate enterprise is found in the statements that are prepared. Although there are numerous stockholders in the corporation, there is usually only one income statement and one balance sheet prepared per period. Also, no matter how many different activities the corporation is engaged in, there is only one set of financial statements which combine all activities of the corporate enterprise. Hence, it is one corporation, one entity, with many interested parties.  

When the auditor audits the books and certifies the statements of a corporate enterprise, he is not working for just any one group, such as management, but he is working

36 Bell, op. cit., pp. 2-3.

directly for the corporation. Since he is working for the corporate enterprise the results of his efforts, the certified statements, should be presented to all interested parties. Hence, indirectly and from an entity approach, the auditor is working for all the interested parties of the corporate enterprise, the entity.

The stockholders elect a board of directors and the board appoints the officers of the corporate enterprise. Along with the election of directors and the selection of officials, the stockholders delegate authority to management to carry on the business of the corporate enterprise. Thus, the owners do not exercise direct control of the corporation but delegate to management the administration of the corporate affairs. Therefore, management exercises direct control over the corporation.

38 The audit report is usually directed to the stockholders but the corporation pays for the service. Someone must be responsible for naming the auditing firm and this will vary between corporations in different states.


40 An excellent summary on the powers and duties of the board of directors can be found in Robert C. Hardy and Robert D. Youle, "The Powers and Responsibilities of Corporate Directors," The Journal of Accountancy, LXXXII (1946) 280-296.

41 Saliers, op. cit., p. 203.
There are times during the life of corporate enterprises when some officials take advantage of the business. The management group fails to realize that they should help rather than hurt the corporation because the management group is supposed to represent the stockholders and certainly an interested party would not hurt himself.\textsuperscript{42}

It is interesting to note that in England, the right to declare dividends rests with the stockholders. Except for dividends on preferred shares and interim dividends, which the directors may declare if the authority is granted in the charter, the directors can only suggest a certain amount of dividends to the stockholders and they in turn vote on it. However, the stockholders have no power to vote themselves dividends greater than the dividends suggested by the board of directors.\textsuperscript{43}

Accounting evolved from three major growth periods in corporate enterprise theory. First, the accountant was concerned only with the owner who was the manager, second, as business grew and more capital was needed, creditors began to exercise more influence and began to demand statements from the owner-managers. The last period developed

\textsuperscript{42} Scott, \textit{op. cit.}, p. 21.

with the divorce of ownership and management. So today, all the interested parties have come into the limelight and the public accountant prepares statements useful to all interested parties. 44

Employees. The position of the employee has changed over the years in corporate enterprise theory. Today, corporations are adopting policies whereby the employees are receiving specially prepared financial statements of the company. 45 Although the cost of these reports is great, the corporate managers realize the importance of having the employees of the corporate enterprise well-informed on corporate matters. Also, in this way, the employees do not feel left out.

There has been comment on the idea of separate reports to the employees and some prefer to have the financial reports to employees and the stockholders the same. No matter which course of action is followed, the fact remains that the employees' place is increasing in importance in the corporate enterprise because of their position as an integral segment of the corporate organization.

Income. The usual connotation of income is an increase

44 MacNeal, op. cit., pp. 70-71.
45 Inglis, op. cit., p. 20.
in the net worth of the corporate enterprise through operations; a loss usually indicates a decrease in the net worth. However, a lawyer will give one definition of income and an economist may give another and if a second lawyer is asked, it is more than likely he will give still another definition. Hence, the meaning of income will vary among the lawyer, the economist, the businessman, and the accountant.

Gilman brings out some of the controversies among the accountants in regard to income when he says,

By some accountants 'income' would be applied to such an item as gross or net sales. By others it would be applied to such an item as gross profit on the theory that net sales cannot be considered income, since in part the sales total is a return of capital represented by the cost of the goods parted with.

The committee on terminology of the American Institute of Accountants recommends that

The terms net income or net profit refer to the results of operations after deducting from revenues all related costs and expenses and all other charges and losses assigned to the period. These deductions do not include dividends or comparable withdrawals.

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46 MacNeal, op. cit., p. 295.

47 Gilman, op. cit., p. 597.

48 Ibid., p. 605.

49 Accounting Terminology Bulletins, prepared by the Committee on Terminology, American Institute of Accountants, New York, Number 2, p. 3.
Balance sheet. By definition, the balance sheet is a statement of balances. The total of all the assets must equal the total of all the claims against the corporation. The claims against the corporation are represented by either liabilities or owners' equity or both.50

The balance sheet is important in the study of the corporate enterprise for it shows the relationship between the assets and the claimants. It is possible to conceive of two different balance sheet presentations for two different theories, the entity theory and the proprietary theory, one represented by \( A - L = C \) and the other, \( A = L / C \) (an analysis of the formulas is given later).

Before 1900, the order of accounts on the credit side of the balance sheet was quite different from today. The balance sheet credit items appeared in the approximate order, "... capital stock, funded debt, current liabilities, reserves, profit and loss."51 There was no breakdown of proprietary items and liabilities but all the credit accounts were intermingled. Hence, all accounts which would be deducted from assets or had credit balances were shown


on the right side of the balance sheet.\textsuperscript{52}

The main purpose of the balance sheet is to give the financial position of the corporate enterprise on a given day and to show how the contributed capital is invested.\textsuperscript{53}

This contributed capital (liabilities and owners' equity) in the balance sheet shows who has creditor and equity claims against the corporation.\textsuperscript{54} Thus, the main divisions of the balance sheet are the assets and the equities with the equities being broken down into liabilities and capital.\textsuperscript{55}

From the usual way of showing assets of the corporate enterprise on the left side and what the corporation owes, liabilities and capital, on the right side of the balance sheet, May\textsuperscript{56} has introduced a new form for the balance sheet. This new statement has capital stock and retained earnings totaled at the beginning of the statement. This total is then compared with the results of current assets less current


\textsuperscript{53} dePaul, \textit{op. cit.}, p. 73.


liabilities, net current assets, to which all other assets
are added, less all other liabilities, which gives net assets.
This type of statement has a tendency towards following the
proprietary theory since the proprietary accounts are placed
first and hence, the impression of importance is given. In
other words, here is the owners' equity and this equity is
represented by the net assets.

It was the practice a few years ago to show net worth
under the heading of liabilities. Although many authors did
not favor this presentation, it was explained as customary
to show the liabilities and net worth under one caption on
the right-hand side of the balance sheet. However,
William Bell, writing as late as 1934, still favored the
term liabilities "... as the heading for the right-hand
side of the balance sheet."58

Formulas. As was brought out in the introduction,
there are two basic formulas used in accounting, \( A - L = C \)
and \( A = \frac{L}{C} \). There are authors who make no distinction
between the formulas and there are others who say that the
formulas are different but do not make any attempt to explain

57 Willard J. Graham and Wilber G. Katz, Accounting
in Law Practice (Chicago: Callaghan and Company, 1932),
p. 11.

58 William H. Bell, Accountants' Reports (Third
p. 20.
the difference. The introduction also pointed out that from a mathematical stand point, both formulas could be different if \( L/C \) is considered a complete unit and hence, as a complete unit the transposition could not be made from \( A = L/C \) to \( A - L = C \).

If there were no liabilities against a corporate enterprise, a formula, assets equal capital could be formed.59 The assumption made here is that all claims against the assets of the corporation are represented by the owners of the corporation's capital stock. Another assumption could be made by saying that assets equal capital, that is, that all of the assets are owned by the owners of capital since assets equal capital. Hence, the first assumption would express either a proprietary approach or an entity approach since the capital represents just a claim against the corporation and the second assumption would express an extremist's proprietary approach since the capital represents ownership of the assets and hence, the corporation would be a mere method of organization rather than an entity.

With the introduction of the liabilities, the theory becomes more complicated. Some say that there is no difference in having liabilities as a deduction from the assets or added

to the capital. The authors contend that one reason for deducting the liabilities from the assets is that it is easier to subtract the liabilities rather than to add the liabilities.

The authors who contend that there is no difference in the formulas and that the reason for both is to facilitate statement making are usually following the proprietary theory. The contention of this school is to determine the net assets of the corporate enterprise since the stockholders are interested only in the net product or $A - L = C$. Hence, liabilities are considered as negative assets and as such, are not owned by the owners of the corporation but are owed to creditors. The position is that the liabilities to creditors can either be shown as deductions from assets or additions to the capital side of the balance sheet. If, however, the liabilities are added to capital the capital account does not represent liabilities of the corporate enterprise but it is used only in regard to accountability.


61 Hatfield, *op. cit.*, p. 2.


63 Littleton, *op. cit.*, p. 188.
to the stockholders for their capital investment. 64

Considering the entity approach, liabilities must always be on the right-hand side of the formula and added to the capital, thus, showing the total claims against the assets of the corporate enterprise. As Sprague 65 brings out, $A - L$ is not valid if capital is considered one of liability because if capital, as an excess of assets over liabilities, is considered one of liability then the formula must be $A = L / C$. It is true that the liability of the corporate enterprise towards its stockholders is not the same as against the other claimants but there is a liability of the corporate entity, to its stockholders. Husband and Thomas bring out the entity and the proprietary theories when they divide the two ideas by saying,

(1) Those who claim that the proprietor owns all of the assets but owes certain amounts to creditors, and
(2) those who hold that both liabilities and proprietorship are merely claims against the assets. 66

Summary. One of the purposes of accounting is to supply the corporate enterprise with the necessary information to carry on the business. Accounting procedures are

64 Bennett, Basic Accounting, pp. 13 and 18-19.
65 Sprague, op. cit., p. 20.
adaptable to large corporations as well as small business units. Accounting has become a necessity for the large corporate enterprises.

The term capital has many connotations. Economists consider capital as all that is invested in the corporation or at least the long-term debt, capital stock, and retained earnings. Others consider capital as owners' equity and still others consider capital as the par or stated value of the capital stock.

A corporation must obtain capital in order to begin operations and the sources are government, private individuals, institutions, or combinations thereof. This capital can be loaned by a creditor or it may be equity capital invested by a stockholder. The corporate relationship with the creditor is debtor-creditor and with the stockholder, residual claimant rather than debtor-creditor.

The stockholder undertakes the greatest risk because he is the last claimant. He suffers losses but he also benefits by the gains. Considering the proprietary theory, the stockholder has some rights and Sprague\textsuperscript{67} contends that these rights are property rights in the assets. The stockholder can order the assets sold and the corporation liquidated if they so desire. However, no other group can force

\textsuperscript{67} Sprague, op. cit., p. 288.
the corporation into liquidation unless there is a default in discharging its duties or the corporation is found guilty of illegal practices by the courts.

As an aid to understanding the entity theory, Gilman and others use the example of the slave in the days of the Roman Empire. Although the slave did not own property; it appeared that he did because he carried on business like any free person. The debts to outsiders were as much a liability to the slave as the amount of capital received from the master. Although the corporation is not a slave, some attempt to say that, like the slave, the corporation is liable to its stockholder for the capital contribution. The corporation is a separate and distinct entity and can contract business in its own name. The stockholders receive a return on their capital investment only when dividends are declared and the payment of dividends depends on the board of directors.

The creditors are sometimes considered as special owners. The creditors contribute capital to the corporation as well as the stockholders do. However, the creditors have a claim against the corporation for a specific amount and for a definite period of time, whereas the stockholders have no claim for any specific amount which must be paid by a certain date. From an entity concept, some extremists have held that there is little or no distinction between the
stockholders and the creditors.

The board of directors is elected by the stockholders and the directorate appoints the officers. The stockholders delegate authority to the management in order to operate the corporate affairs. With the authority to operate the business, management, in most large corporations, exercises direct control over the capital of the corporation. Some management groups have taken advantage of their positions at the expense of stockholders.

The employee's position has changed over the years in corporate enterprise theory. Although they were not considered too important in the past, now they are given more consideration. Special financial reports are given the employees or in most cases they at least receive the same annual report that is given to the stockholders.

The balance sheet is one of the major financial statements prepared for the corporation. It is a statement of balances and contains the assets, liabilities and owners' equity. In statements of past years, the creditors' claims and owners' equity are shown as liabilities. Today, however, the creditors' claims are shown as liabilities and the owners' claims are shown as owners' equity.

There are two formulas used in accounting to represent ownership, \( A - L = C \) and \( A = L / C \). Using a mathematical formula to try and explain a theory, \( A - L = C \)
represents the proprietary theory and \( A = L / C \) represents the entity theory. Although many authors use either formula, they never make a distinction between the two. If \( L \) and \( C \) are considered completely different units, a transposition could be made and both formulas would be identical. However, if \( L / C \) is considered as a single unit and similar in nature, then neither \( L \) or \( C \) could be separated from the unit.
CHAPTER VIII

ANALYSIS AND CONCLUSIONS PERTAINING TO
THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

This study was made in order to determine what is meant by the entity theory and the proprietary theory of corporate enterprise. After reviewing the available material, it is evident that neither theory has been well developed in the literature. Most authors will only suggest a part of one theory and a part of the other theory without any comparison or explanation. As a result, assumptions and interpretations have to be made in the light of their total contribution for one to formulate the theories.

The entity theory. The entity theory considers the organization with all its component parts and hence, has its foundation in the function of the respective interests of the corporate enterprise. It is management who coordinates all of these parts into a usually well organized operating unit. Thus, it may be said that the entity theory is a managerial approach to the theory of corporate enterprise.

The corporation is a separate entity but it is impersonal in nature. Since it is impersonal, there must be
a reason for its inception. The corporation's existence, following the entity approach, is for the benefit of all the contributing persons and society in general. The individual contributors lose their identity because the main consideration is the corporation and not any particular group within the corporate structure. It makes little difference to the corporate enterprise who the stockholders, creditors, management, or other contributing parties are because they can be continually changing but the corporation exists indefinitely. The stockholders and creditors are the suppliers of capital to the corporate enterprise.

The professional managers perform the duties of operating and administering the corporate affairs. Management has physical control over the corporate assets. All reductions in corporate assets represent a cost to management and hence, to the corporation. Distribution of corporate income to the stockholders is just as much a cost to the corporation, according to the entity theory, as interest because it represents payment for the use of invested funds.

In accounting, the formula $A = L / C$ best expresses the entity theory. The corporation own assets and has obligations. The assets are represented by $A$ and the obligations are represented by $L / C$ (liabilities and owners' equity). From a functional standpoint, $L / C$ are all obligations and there is little reason to separate them. Hence,
L/C is considered a parenthetical unit, and as in algebra, if one wishes to transpose, the whole parenthetical expression must be transposed and not the individual parts.

The proprietary theory. The proprietary theory is a stockholder's approach to the theory of corporate enterprise. The stockholder owns the capital stock which represents a residual interest in the assets of the corporation. The stockholder is the last recipient of distributed corporate assets.

The usual purpose of a corporation is to make a profit for the benefit of its stockholders. When stockholders associate themselves to form a corporation, the purpose is for their personal gain. The fact that many other individuals may benefit from the corporation's existence does not alter the original purpose of the corporation, i.e., to benefit the stockholders.

As the corporation grows in physical and financial size, it is usually impossible for the stockholders to perform all of the functions of an owner such as meeting all of the operational and financial needs of the large corporate organization. Hence, duties with responsibility are delegated to others (management) by the stockholders. This theory holds that the persons who perform these duties are directors and officers of the corporate enterprise,
they actually are employees of the stockholders. The stockholders elect the directors who appoint the officers but, the stockholders can replace the directors and thus cause a change in the officers. People lose sight of the fact that management is performing a function; the authority being delegated to them by the stockholders.

The corporate enterprise is a form of organization which is used to protect not only the personal wealth of the stockholders but to protect all persons doing business with the corporation. The stockholders are the instruments behind this impersonal being and own it according to the proprietary theory. It takes the stockholders to set the wheels in motion in order to commence operations. It takes the stockholders to keep the wheels in motion.

In accounting, the formula \( A - L = C \) best explains the proprietary theory. Here, a definite distinction is made between the liabilities and the owners' equity. In owning the corporation, the stockholders own the residue after all other obligations of the corporation are met. If one wishes to express the proprietary theory by using the formula \( A = \frac{L}{C} \), it must be remembered that \( \frac{L}{C} \) is not a parenthetical expression but represents two completely different segments, one of a debtor-creditor relationship and the other a residual claimant relationship. Therefore, the transposition of the formula from \( A = \frac{L}{C} \) to \( A - L = C \)
The corporate enterprise is an organization chartered by the state for a specific purpose, and it is impersonal in nature. Because it is impersonal, it needs personal beings in order to operate. It is management who supplies the personal factor.

Along with the personal beings who operate the corporate enterprise, capital is needed. Money or goods must be supplied to the corporation if anyone expects it to operate. Hence, other contributors to the corporate enterprise are the furnishers of capital (creditors and stockholders). The creditors supply long and short term capital and the stockholders provide equity or owners' capital.

One of the difficulties in understanding the entity theory and the proprietary theory is determining who owns the corporate enterprise. Some theorists claim all contributors are such an integral part of the corporation that they in effect own the corporate enterprise. Others say that the corporation is owned by the stockholders and hence, the stockholders are the important factor when considering the corporation.

To be an owner of a thing, there are three important factors: control, income, and risk. These three factors must be inherent in a person if he is to be considered an
owner. Even though there are varying degrees of control, income, and risk present in all claims, the owner usually has the greatest combination of control, income, and risk.

From the inception of the corporation, the advocates of the association theory (a proprietary approach) hold that it is the stockholders who give the authority to the corporate enterprise and the state recognizes what already exists. This form of organization, with its limited liability and other benefits, is merely a method of doing business rather than a being per se. The stockholder is the important factor and other parties are just instrumentalities used by the stockholders for their benefit. This is the proprietary theory in the extreme sense but it is held by some. Although the laws pertaining to corporations expressly state that the corporate enterprise owns the corporate assets, the proprietary theorists would claim that the corporation is acting like a trustee who uses the corporate assets for the benefit of all the stockholders.

Another contention is that the capital stock represents ownership of the corporation. The stockholders own the capital stock and hence, they own the corporation. From this point of view, what does the stockholder actually own? The stockholder doesn't own the assets of the corporation because the corporation, according to law, owns the assets. He doesn't own the segment of the assets represented by the
retained earnings of the corporation because again, the corpo-
rate enterprise holds the assets and distributes them, in the
form of dividends, only after the board of directors elects
to declare and pay dividends. Hence, the stockholder really
owns an anticipated or implied promise of the corporation
to pay dividends in addition to other rights. Only when
dividends are paid does the stockholder receive income on
his capital contribution.

Following the entity extremists, the stockholder is
merely an investor and not an owner. The writers who con-
tend that the stockholder is merely an investor do not define
investor. However, they seem to hold that investor means
stockholder rather than the usual connotation of investor
as stockholder or bondholder. And yet, going deeper into
the concept of a stockholder as an investor and following an
entity approach, there is virtually little difference between
some types of stockholders and some types of bondholders.
In this light, and following an entity approach, the stock-
holder, as a mere investor would have to be considered as a
creditor (not as a general creditor but as a special or in-
ferior creditor).

If the stockholder is to be considered as a special
creditor or inferior creditor, he must have a direct claim
against the corporation. The stockholder, however, cannot
force the corporate enterprise to return his capital
contribution nor can he force the corporation to pay a return on his capital contribution. The stockholder's only right or claim to a return on his investment is when dividends are declared. The corporate enterprise cannot pay dividends to some stockholders and not to other stockholders holding the same class of stock or, in liquidation, the corporate enterprise must distribute to each stockholder his proportionate share of the corporate assets. Up to the point of liquidation or declaration of dividends, however, the stockholder has no direct claim against the corporation for any specific amount to be paid at any specific time.

The function of a creditor is to loan money or goods. If the stockholder is considered as a creditor, following an entity approach, his purpose would be just money lending. However, the purpose and function of a stockholder is greater than and different from a lender of funds. The stockholder does not lend funds to the corporation (capital contribution and retained earnings) but he commits funds to the corporation. The corporation, in most cases, is not indebted to the stockholder for any specific amount as it is to its creditors.

The understanding of claims against the corporate enterprise is a point often overlooked in the entity theory. Because a person is a claimant against the corporation, this does not mean he has a claim against the assets or even owns
the corporation. Only in cases where the claimant has a lien against a particular asset can one think of a claim against the assets of the corporation and even here, the claim is only contingent. Although, in some borderline cases, the claims of some interested parties do not appear to vary considerably, the differences can be great. According to the entity theory, for example, the difference between stockholders and bondholders does not appear to be prodigious in the large corporation. The bondholder, however, has a claim against the corporation for a specific amount to be paid within a specified time. The stockholder, on the other hand, has a residual claim which is not for any specific amount nor must be paid. The bondholder can demand payment when the debt is due but the stockholder cannot demand payment for there is no debt arising from his capital contribution.

In owning a share in the corporation, a stockholder has title to a portion of the total corporate capital stock. The capital stock in turn represents a bundle of rights. As owner of capital stock the stockholder does not own the corporate assets but he owns all the rights which the capital stock relays. The rights of the stockholder are in turn subject: first, to the rights of the government because laws can be and are passed restricting the property rights of individuals; secondly, to the rights of the
creditors; thirdly, to the rights of other interested parties. Therefore, the stockholders’ rights in the corporation are residual; he receives only the residue after all other parties’ claims are satisfied.

The right to vote in a corporate enterprise is restricted to stockholders, except in unusual cases when creditors are permitted to vote on all or part of the directorate. The purpose of the voting right is to elect the board of directors who act for the stockholders in the management of the business. The board of directors appoint the officers and together they perform the duties necessary to operate the corporate enterprise. It is the stockholders who vote on the directorate and hence, the stockholders have the legal right to replace the management group. According to some entity theory extremists, the stockholders need not have the voting right because management can and in exceptional cases does choose the directorate. However, it still takes the yes or no of the stockholder, whether by proxy or direct vote, to vote in the directorate.

The separation of ownership and control of the corporation has caused many to believe that the stockholder is an inferior creditor. When the stockholders were the managers, the new theories brought about because of the divorce of ownership and control were nonexistent. Control is necessary if one is to be considered an owner of a corporate enterprise.
However, it is not necessary to have physical control of the property to be an owner. Physical control of the property can be surrendered by contract. When a person leases land to another, he gives up effective control of the land but he still owns it. At the expiration of the lease, effective control of the land reverts back to the owner. Management has effective control of the corporation but this control is delegated by the stockholders. In order to perform the management function, it is sometimes necessary to delegate control. In the corporate enterprises, management cannot possibly carry out its duties if it does not have control of the corporate enterprise. Because management has control of the corporation and deals with the creditors, employees, government, society in general, and stockholders, this does not mean that management is an entity in itself but management is performing tasks which the stockholders delegate to them. Thus, management is actually performing a function of the organization for the benefit of the stockholders.

If management was working for all the interested parties, all the interested parties should have a voice in the selection of the management group and its changes. However, the stockholders are the ones who select the management group and it is the stockholders who can change the management group. The management group is the employee of
the stockholders and any action involving management is restricted to the stockholders or their delegated agents.

In some corporate enterprises management has been able to perpetuate itself. The reason is that the stockholders permit it and the reason is not that management is the deciding force behind their own perpetuation. The management group is able to influence enough stockholders into its camp and hence, management remains in power. However, as soon as the opposition is able to convince enough stockholders that they can perform the functions of management better, then, the management is replaced and the new group takes over control. In the New York Central Railroad proxy fight, a group headed by Mr. Robert R. Young was able to unseat the management group because the stockholders felt that Mr. Young's group could give superior service and as a result more profits to the stockholders. Although Mr. Young was extremely influential, it was still the vote of the stockholders that brought about the change in favor of Mr. Young's group and not the new management group per se.

Some professional managers are extremely influential and they are able to gather the necessary stockholders' votes to maintain their position in the corporation. Their influence may be the result of being good managers or personal contacts. Because management is influential and
solicits the votes of the stockholders, this does not mean that the stockholders are relinquishing any of their rights as owners. The stockholders favor one group of managers over another to perform the tasks of managing the corporate affairs.

Along with a management group, the corporate enterprise has employees. The employees are an integral part of the organization because labor is necessary to operate the business. The question, however, is not the necessity of labor but what part labor plays in the entity theory and the proprietary theory of corporate enterprise, if any.

The employees receive wages for services rendered to the corporate enterprise. The employees have a direct claim against the corporation for their wages and they are general creditors when wages are owed to them by the corporate enterprise. These wages are considered as an expense by the corporation. However, some theorists following the entity theory believe that wages of the employee not only include earnings for services rendered but also a distribution of the corporate enterprise's income. It is true that some employees and some managers receive a bonus which is considered a percentage of the corporate income. The new guaranteed annual wage contract of Ford Motor Company and General Motors Corporation is claimed by some to be a return paid to the employee for services not rendered and hence, a gift.
brought about by the distribution of corporate income to the employees. But, is it not also true that the total cost of labor as far as the corporation and the proprietary theory are concerned is the total wages paid to the employees? It makes little difference if one calls a distribution of corporate income bonuses, guaranteed annual wages, and other fringe benefits, for they still represent a cost to the corporation to have its products produced, following a proprietary approach. The effect of all these benefits results in a higher unit cost of labor to the corporation and ultimately to the stockholders rather than a distribution of the corporate income.

Some corporate enterprises have instituted the idea of employee stock ownership. These corporations have set up plans whereby the employee can accumulate funds to purchase the corporate capital stock and some corporate enterprises have gone so far as to guarantee the purchase price of the capital stock purchased (this guarantee would make the employees' position one of an owner and a creditor at the same time because the corporation would be contingently liable for the fluctuations downward in the market price of the capital stock). The purposes behind the employee stock purchase plan are numerous and worthy but from a corporate viewpoint, what is the significance? Since the employee is already an integral part of the corporate organization and
receives all the above mentioned benefits, which are considered a distribution of corporate profit, there is no reason for his becoming an owner of the corporation directly following an entity approach. As an owner, however, the employee takes his chances along with the other stockholders for income (dividends) but as an employee, he receives not only wages but a part of the corporate income. With strong labor unions and the labor laws today, the employee is in a better position as an employee than as a stockholder for receiving compensation from the corporate enterprise. Having the employees become direct owners of the corporation is a proprietary viewpoint because the employee is now a stockholder and not just a segment of the corporate organization. Hence, along the proprietary reasoning, the employee is important because he is a stockholder and not because he is an employee.

At different times throughout the history of this country, the government has taken an active part in corporate affairs. The last law which permitted the government to loan funds directly to corporations was the Reconstruction Finance Corporation which terminated all of its activities in 1954. The RFC was set up to lend money to the small business organizations and in part to large corporations as well. In its capacity as money lender to the corporate enterprises, the government became a creditor of these
The loans of money to the corporate enterprise were usually repaid but whenever the money was not, the government took its place along with the other creditors. Hence, the government became an important segment of the corporation because in this case it was a creditor.

At times, the government has formed corporations and these government owned corporate enterprises take their place along with private corporations. The courts have declared that even though these corporate enterprises are owned by the government, any suits against these corporations are not suits against the government but they are against the corporation. Hence, the separation of the entity from the stockholders even when the government is the stockholder.

In order to operate the government, taxes are levied on the income of personal and impersonal beings. The purpose of taxation is to raise money but the government must also consider injustices in its tax program. If a tax law is passed and the courts deem it unjust, it is declared unconstitutional and hence, not enforceable. The taxes levied on the income of corporations is considered constitutional after many court cases.

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1 One of the largest borrowers of government funds was Kaiser Motors Corporation which owed the government as much as $36,911,779 in 1951.
When income taxes were levied on real and corporate persons, each taxpayer was considered a separate person. The corporation, according to law, is taxed as a separate person and hence, following the entity approach, the corporate tax is not considered unjust in this light. However, the stockholders began to clamor "injustice" because of the tax on corporate income and dividend income (double taxation). Considering the stockholder as the owner of the corporation with the corporation merely as a form of organization, which is an extreme proprietary approach, one may arrive at a conclusion of a double tax injustice. With the corporation as a separate entity, however, there is no injustice and the stockholder is merely trying to avoid paying taxes.

After considering taxes and the complaints of double taxation, one is led to consider income. Since all of the interested parties are trying to claim the income of the corporation, is there any income in the corporation or, in other words, does the corporation make a profit? Income is the residue after all deductions are made. If the contention of the stockholders is correct when they claim the income of the corporation is theirs (the proprietary extremists), then the corporate enterprise makes no profit. Or, if the corporation is established for the benefit of all interested parties, there would be no profit either (the extreme corporate entity viewpoint), because all of the
gains would be distributed, either now or at a later date, to the benefactors (any gains would belong to them). So, from both extreme points of view, the corporation never makes a profit.

The retained earnings of the corporation are the accumulated gains from operations before they are distributed to the interested parties. In reality, who has a right to the assets represented by the retained earnings? The assets are owned by the corporate enterprise. The stockholder has a right to corporate earnings only when dividends are declared and not until that time. According to law, the stockholder does not own the assets of the corporation and hence, his investment in the corporation represents only a bundle of rights paid for by his capital contribution. This contribution is made in anticipation of dividends but there is no one or nothing which can force the corporation to pay dividends except in a few rare cases which were previously cited. Therefore, the assets represented by retained earnings do not belong to the stockholders or other interested parties. The only way the other interested parties could receive a distribution of these assets would be for the corporation to make a gift, following the proprietary theory. Although bondholders and some creditors may have a prior lien against a few particular assets of the corporate enterprise, the creditors and bondholders do not own the assets
and cannot claim the assets except in case of default of payment.

If the assets produced by profits belong to the corporation, then the corporate enterprise does make a profit. It seems only logical that the assets represented by earnings should belong to the corporation. The corporate enterprise is a separate entity established by the state and can sue or be sued in its own name as any natural person. Laws are passed by the state and federal governments which govern the operations of the corporate enterprise. The corporation obtains funds and goods from creditors and stockholders and places them into operation for the purpose of making a profit. It is true that the assets obtained because of the profits may ultimately go to creditors and stockholders when the corporate enterprise is liquidated and currently, as dividends are paid out, but assets, up to the time of liquidation, belong to the corporation. Also, the consensus is that a corporate enterprise makes a profit.

Generally accepted opinion often plays an important part in theory and at times, it is used as a proof of the theory. The persons questioning the theory that a corporation makes a profit are extremists, both entity and proprietary followers, but they are few in number. The entity and proprietary extremists lose sight of the fact that the corporate enterprise owns the assets produced by profits.
If the corporation makes no profit, there can be no increase in the assets owned by the corporation because of operations. Hence, when someone asks where the new assets come from, assuming the creditors and the stockholders do not contribute more, there can be no reply. Whenever the assets owned by the corporation actually increase and neither the creditors nor the stockholders contribute to the corporate enterprise, the source of the assets must be profit. Therefore, a corporation can and does make a profit.

From a corporate entity viewpoint, considering the corporate enterprise as an entity and separate from all interested parties, dividends, when declared and paid, represent just as much an expense as interest because it reduces the corporate assets as interest does. Dividends are the cost of the capital invested by the stockholders. Some theorists have held that dividends should be divided into two parts, interest and profits. The stockholder should receive a return for his investment in the corporation. However, the amount to be paid as interest and as profit is always disputed. If a just return would be the same as the interest paid to bondholders, the difference in amount would be profit. Such a contention would put a price tag on the cost of risk and hence, the cost of risk between the stockholder and the bondholder would be equal. Such reasoning does not seem logical because there is a definite difference if one just considers
claims. The bondholders must be paid their interest each period but the stockholders cannot demand a return on their investment. Therefore, the dividend should include more interest than distributed profit or perhaps no distributed profit at all. The entity idea would contend that the dividend represents an expense in total to the corporation.

Dividends are declared out of retained earnings and are payment for the use of capital funds or for the entrepreneurial function. An entrepreneur is one who assumes the risk and management of a business. If the entrepreneur must directly assume the risk and management of the business, by strict definition, there are no true entrepreneurs in the large corporate enterprise. Hence, the meaning of the term has changed and today, the entrepreneur can be anyone of the interested parties in a corporation or all the parties in various combinations. The most accepted version is, however, that the management or the stockholders are the entrepreneur as both contribute to the entrepreneurial function.

In considering the entity and the proprietary theories, one is led to consider the viewpoint of management and stockholders. The management group is working for the stockholders since the stockholders elect and appoint them and can replace them. However, as the stockholders consider management as an instrumentality, so can management consider the stockholder as an instrumentality. Since the corporation is impersonal
in nature, the only persons who could benefit by its existence would be the parties coming into contact with it. Thus, the corporate enterprise would exist for the benefit of all parties and not for any single group. Such reasoning would lead to the entity theory or a managerial approach. On the other hand, a stockholder's approach would be the proprietary theory.

Conclusions. The entity theory and the proprietary theory are entirely different and serve two different purposes. The entity theory serves to demonstrate the oneness of the corporate organization, giving weight to all the interested parties as claimants against the corporate enterprise. It is a managerial approach to accounting for the enterprise because as operators of the corporation, management is interested in all contributors of capital as a source of capital funds and the cost of obtaining these funds to the corporation. Therefore, the stockholders are treated as a part of the whole like the creditors, employees, and government. The management group tries to perform its duties for the good of the corporation which is the total function of management. From a managerial point of view, the stockholders perform the function of capital suppliers but this does not have any relationship to ownership. The stockholders do not own the assets of the corporation because they are owned by the corporate entity itself but from a proprietary
approach, the stockholders do own the corporate entity.

The entity theory deals in assumptions which overlook the facts. Because most people benefit by the large corporation's existence, this does not mean that the position of the stockholders as owners is lost. How much can a stockholder give up before he loses his position as an owner? Whenever a stockholder gives up his right as the ultimate authority, his position is weakened to a point of an inferior creditor. By contract, a stockholder can relinquish his right to vote in corporate matters and therefore, he loses complete control of the corporate organization. The true owners of the corporate enterprise are the stockholders who have the right to vote in corporate matters and by so voting, control the activities of the corporation and therefore, they are the real entrepreneurs, the owners.

Along with the right to vote, another important factor is the position of the stockholder as to claims against the corporate enterprise. The stockholder has no direct claims against the corporation for anything except for dividends when they are declared. The stockholder's rights are residual in nature which is the usual criterion of an owner. The owner of anything has all rights to his property subject to the rights of others, or, in other words, he has the residual interest.

In most cases, the application of the entity theory or
the proprietary theory will not affect the results from an accounting standpoint. At times, however, the use of either theory will produce different results. Consider, for example, the idea of net worth. By definition, net means that something has been deducted and since it is net worth, something has been deducted from the worth. The net worth section of the balance sheet represents the stockholder's interest in the corporate enterprise and is the residue after liabilities are deducted from the assets. This is the proprietary theory and therefore, in this light, the idea of net worth has meaning.

Following an entity approach, net worth has little, if any, meaning. The corporation receives funds from many sources and as a result is accountable to all interested parties for their capital investment. New laws and government regulations have caused changes in management and accounting thinking and as a result the accountability to others is stressed more than the owner's interest. An entity approach is then followed and considered superior to the proprietary approach by some. Hence, management has the corporate assets and is accountable to all the suppliers of capital. Therefore, assets equal equities with the main consideration being accountability for all the equities.

In the net worth section one may find several classes of capital stock and retained earnings. The capital stock is
segregated into the various types of capital stock and totaled. This total represents the sum of contributed stockholder's capital. However, the retained earnings are not segregated to show the relationship to capital stock but they are shown as a total figure. From an entity approach, it makes little difference who receives the assets represented by the retained earnings for the entity is only interested in accounting for its obligation.

The idea of net worth has changed over the years and today, the theory that net worth represents a trust fund for creditors is gaining impetus. The profits of the corporation cannot be withdrawn by the stockholders when they desire but the process of declaring dividends by the directors must proceed. The funds of the corporation may be restricted so that dividends cannot be declared and hence, even a change in management could not cause dividends to be declared. Although the net worth of the corporate enterprise represents the owners' equity, the stockholders have little control over it and their rights are limited as to the disposition of corporate assets represented by the net worth.

The proprietary theory of corporate enterprise is the more logical. The stockholders control the corporation through their right to vote. The stockholders appoint and have the power to discharge the management group. Management, in turn, deals with employees and creditors because of
the authority granted them by the stockholders. There is nothing compelling the stockholders to perform any duties as long as they act within the law. Although the stockholders cannot force the corporation to distribute income, a new directorate can be elected which will be more favorable to the stockholders and hence, income would usually be distributed. All of the ultimate power rests with the stockholders and they are the recipients of the corporate residue.

Following the proprietary theory, the emphasis is placed on the stockholder whereas following the entity theory, the emphasis is placed on the corporate entity. Along the entity line, the corporation is considered a real person with assets and obligations. The entity theorists consider the entity as the owner of the assets but going back to the three factors of ownership (control, income, and risk), the corporation actually has only rights in the assets.

The next step is to admit that the corporation, per se, can have actual ownership. Actually, for legal purposes and as a form of organization, the corporation owns the assets but considering control alone, the corporate enterprise never can nor does control the assets for actual control must rest in persons. Therefore, one of the factors necessary for ownership is missing and ownership by a corporation is a legal fiction. Although ownership by a corporate enterprise is a legal fiction, it cannot be overlooked in
corporate enterprise theory because actions of individuals are governed by the law.

Although the proprietary theory is more logical, there is a tendency to shift more and more towards an entity approach. Because of the vastness of the large corporations, the investment of the individual stockholders is decreasing in relation to the total contributed capital. In the past, the capital contributors to the corporation were made by a few whereas today, some corporations have almost a million different stockholders. As an individual, the stockholder's position is nil (this would depend on the number of shares held), but this does not invalidate the fact that the stockholders as a group control the corporate enterprise and that they receive the corporate residue. The entity theory would consider the insignificance of the individual stockholder in relation to all the interested parties of the corporate enterprise and therefore, the entity theorists would conclude that the important consideration is the corporate enterprise which is made up of many units coordinated by management. A complete shift to an entity approach, however, at the present time, seems to be too drastic a change for such a change would involve a revaluation of ideas in economics, finance, management, taxes, law, and accounting.
CHAPTER IX

SUMMARY OF RESEARCH
ON THE PROPRIETARY THEORY AND THE ENTITY THEORY
OF CORPORATE ENTERPRISE

The corporate enterprise is chartered by the state and enjoys all of the privileges and rights granted to it by law. The corporate entity exists independently of its stockholders, managers, creditors, employees, the government, and society in general.

Law. In law there are two theories pertaining to the granting of authority to corporations. The fiction theory holds that the state grants the authority, and therefore, this being is completely independent of all interested parties. The association theory holds that the state merely recognizes what already exists. The association of the stockholders is the important factor and the stockholders transfer their rights to the corporation. Hence, there are two theories in law pertaining to the corporate enterprise. The fiction theory follows an entity approach and considers all the interested parties of the corporation and the association theory follows a proprietary approach and considers the stockholders as the important factor in the corporate enterprise.

Taxes. In taxes, there are two viewpoints of corporate
enterprise presented. One considers the corporation as being owned by the stockholders and as such, whatever the corporate enterprise owns the stockholders own. The other viewpoint is that the corporation is entirely separate and distinct from the stockholders, and therefore, the stockholders are merely a part of the whole corporate organization. As exponents of the first idea, the proprietary theorists claim that there is a double tax levied on income because all taxes paid by the corporation are indirectly paid by the stockholders. The other idea (the entity theory) holds that there is no injustice because corporate income taxes are levied on a separate and distinct entity even though it is impersonal. The government is not interested in the entity theory or the proprietary theory of corporate enterprise but when injustices occur, the government usually takes steps to remedy the situation. The government, however, is interested in obtaining funds in order to operate its facilities and levies taxes on all persons, natural or otherwise.

Investments. The writers in investments follow two lines of approach to corporate enterprise theory. One is the proprietary theory which holds that the stockholders are the owners of the corporation. The other approach is the entity theory which holds that the stockholders are merely investors and not owners. The connotation of a mere investor is that
the stockholders are inferior creditors. The stockholders have lost their position as owners because of their own passive attitude. When buying capital stock in a corporation persons are not thinking usually in terms of ownership but they are thinking in terms of investing for income (dividends) and capital appreciation.

Management. Management's importance has increased over the years. In early corporate enterprises, the management function was performed by the owners of the corporate enterprise but as the corporation increased in financial and physical strength, it became necessary to employ professional managers because the owners were not able to cope with all the corporate problems. Hence, the divorce of ownership and physical control became necessary in the large corporate enterprises. As the corporations became larger and more people became stockholders, the attitude of the professional managers changed from considering just the stockholders to considering all of the interested parties: stockholders, creditors, employees, government, and society in general. Hence, management can be considered as performing the function of managing the corporation's affairs for the stockholders or as an entity in itself working for all of the interested parties.

Economics. In economics one finds traces of the proprietary theory and the entity theory. According to a strict
interpretation of the entrepreneurial idea, the proprietary theory of corporate enterprise is favored. However, economists usually take a broader viewpoint of the corporation. They consider the corporate enterprise in relation to society as a whole and therefore, they seem to favor the entity theory. The corporate enterprise is a combination of many factors and as a result many persons benefit by its existence which is almost immortal.

**Accounting.** One of the purposes of accounting is to supply the corporate enterprise with the necessary information to carry on its business activities. In supplying this information, the accountant must make some basic assumptions with respect to certain transactions. He must consider if the corporation is the business of the stockholders and therefore, a proprietary approach or if the corporation is a combination of important factors and therefore, he must account for just the corporate entity, which is an entity approach. Accountants will differ in their decisions as to the assumptions to be made but there are definitely two independent theories. The application of these two theories may not be exactly independent, however, for parts of each may be accepted and the rest rejected. The proprietary theory is a stockholders approach and considers the corporation as being owned by the stockholders and that the residue of corporate assets over
corporate liabilities represents the owners equity. On the other hand, the entity theory is a managerial approach and considers the entity as a whole unit. The corporation is accountable to all interested parties so that assets equal equities. The formulas used to express these two theories are: the entity theory, \( A = \frac{L}{C} \); the proprietary theory, \( A - L = C \).

**Accounting for the corporate enterprise.** There are two alternatives when accounting for the corporate enterprise; first, shall the stockholders' approach be followed (the proprietary theory) or secondly, shall a managerial approach be followed (the entity theory).

Following the entity theory, the stockholders are considered as a part of the whole corporate structure that is combined through the efforts of management. The entity theory is a functional approach to the corporate enterprise and considers the entity as accountable to all interested parties. Emphasis on ownership of the corporation is not important because the corporation owns the assets and has obligations to many parties. Hence, the main idea is to account for the corporate assets and the obligations of the corporate enterprise. It makes little difference who these parties are because the important consideration is the entity *per se.*
Following the proprietary theory, the stockholders are considered as the important segment of the corporate enterprise. The stockholders vote for the management and indirectly control the activities and policies of the corporation. The purpose of the corporate enterprise is for the benefit of the stockholders although others benefit as well. The accountant must account for the assets of the corporation as well as the corporate obligations. A distinction, however, is made in considering corporate obligations from a proprietary approach because the stockholders' capital contributions are not an obligation of the corporation; there is no specific amount or a specified time period. The obligations of the corporate enterprise are to the creditors and not to the stockholders. The stockholders' interests are residual in nature and hence, the net worth or the stockholders' equity section of the balance sheet represents the residue of corporate assets less corporate liabilities.

After reviewing the material on the proprietary theory and the entity theory of corporate enterprise as presented in law, taxes, investments, management, economics, and accounting, it is evident that there are numerous conflicting ideas. Because of these conflicting viewpoints much confusion is caused when trying to make a clear approach to the corporate problems. A great deal of the difficulty could be alleviated and material benefit gained if a more uniform
approach to the problems of the corporate enterprise were followed by theorists in law, taxes, investments, management, economics, and accounting.
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VITA
VITA

Arthur Theophile Roberts, son of Theophile Joseph and Adnese Lussier Roberts, was born on the twenty-ninth day of July, 1926, in Pittsfield, Massachusetts.

He attended public schools in Pittsfield, Massachusetts, and graduated from high school in June, 1944. From February, 1946 to February, 1950, he attended Boston College and received a Bachelor of Science in Business Administration Degree. In September, 1950, he accepted a graduate assistantship in the College of Business Administration, Boston University. At the same time, he entered the Graduate School, and in August, 1951, received a Master of Business Administration Degree.

In September of 1951, he accepted a graduate assistantship in the Division of Research, College of Commerce, Louisiana State University, and enrolled in the Graduate School to continue his study towards the degree of Doctor of Philosophy in accounting. In September, 1954, he taught half-time in the Accounting Department and in February, 1955, he taught full-time. He is at present a candidate for the degree of Doctor of Philosophy.
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Candidate: Arthur Theophile Roberts

Major Field: Accounting

Title of Thesis: The Proprietary Theory and the Entity Theory of Corporate Enterprise

Approved:

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Dean of the Graduate School

EXAMINING COMMITTEE:

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Date of Examination:

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