The Accounting Representation of the Enterprise Entity: An Historical Perspective

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Abstract Accounting scholars, standards-setters and preparers have been confronted with a new financial reporting paradigm that has displaced the traditional focus on accountability of the enterprise entity to its stakeholders (including shareholders) and on the general interest. This focus was common to both static and dynamic accounting approaches in continental Europe, as well as to both proprietary and entity accounting perspectives in North America. This chapter develops three conceptual and practical lessons driven from a comparative analysis of traditional and modern accounting paradigms: (i) the enterprise entity should be distinguished from its markets of reference; (ii) fair value and discounting do not belong to accounting; and (iii) accounting should not follow the market, but the market pricing process may take advantage from an accounting lighthouse. Illustrative examples are then taken from the international financial reporting standards concerning intangibles, goodwill and financial liabilities. According to this analysis, the market-based view on accounting is flawed and undermines accounting suitable connection with law and economics of the business firm as an enterprise entity.

1 Introduction

Currently as Tenured Research Fellow of the CNRS [Centre National de la Recherche Scientifique—French National Centre for Scientific Research], I have been working on accounting issues for some 20 years. My first meeting with Jacques Richard was during the preparation of my French-Italian doctoral dissertation (2000–2003), when we discovered and shared our common passion for accounting theory in historical perspective. At that time, we were observing the advent of a new historical trend initiated by US and International accounting standard-setting bodies with the aim of imposing a new 'financial reporting para-

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D. Bensadon, N. Praquin (eds.), *IFRS in a Global World*,
DOI 10.1007/978-3-319-28225-1_10

digm' that had been theorized as early as the 1970s, above all by researchers in North America. In fact, this new paradigm had been termed an "accounting revolution" in the 1980s (Beaver 1981). This revolution changes the status and role of the firm as an enterprise entity—formerly the locus of accounting—as well as the way in which corporate income is defined and represented. Accordingly, the metrical connection of accounting figures to share market prices has started to dictate the meaning and role of accounting for business and society, while the traditional focus on accountability of the enterprise entity to its stakeholders (including shareholders) was progressively neglected, and the general interest displaced.

Because my background was in mathematical economics [1990–1995] rather than in accounting, I spent about 10 years studying a large number of major authors to carry out my research. In the process, I became familiar with several accounting traditions that we addressed in a collective work in which Jacques Richard has presented the French national tradition (Biondi et al. 2012b).

In the nineteenth century, accounting theorists and practitioners discussed how to classify accounting elements into several account classes. Concerned with "form" and technicalities, they gave little thought to the economic "substance" of accounting. Starting in the late nineteenth century and extending into the first three decades of the twentieth, the proponents of a scientific revolution heralded the emergence of a new accounting paradigm (Richard 1996). This latter paradigm made the firm as an enterprise entity the centrepiece of control and accountability (Biondi 2008a, b, 2010; Biondi et al. 2007). How accounting elements are defined and classified acquires meaning and purpose based upon the scope and purpose of this accountability, which is to define and represent the income to and position of the enterprise entity. Accounting thought of that time can be broken down into four basic models:

In the traditions of Continental Europe, a static model focused on measuring changes in wealth through the enterprise properties in contrast to a dynamic approach that seeks to determine the operating (i.e. productive) results generated by the enterprise as a whole.

In the North American tradition, the distinction is between an ownership perspective concerned with representing the wealth accruing to the proprietor-entrepreneur, and the enterprise entity approach, which well may be related to both the Marginalist Revolution in economics, and the emergence of institutional economics at the time, with its focus on representing the generation of income for the satisfaction of all stakeholders, including shareholders (Biondi 2012).

Although the dynamic approach and the entity approach dominated the twentieth century prior to the advent of the new financial reporting paradigm, all four models placed the enterprise entity at the centre of the accounting system. The main scope and purpose was not to produce information for investors active on financial markets, but to design a control system useful to all stakeholders (including partners and shareholders) with joint interests in a business venture whose ongoing profits and losses they share. Thus, whether preference was given to an ownership and static approach or to an entity and dynamic approach, the enterprise and its accountability invariably remained the primary focus.

In the 1970s, however, a number of regulators and theorists began shifting away from this view of the accounting information and representation required for the enterprise and its income, towards an emphasis on the market, particularly the share market. Their belief was that current market prices at closing dates should be used as the basis for information provided to investors in financial markets. Therefore, they developed an approach that more or less explicitly viewed the enterprise as a portfolio of disparate assets and liabilities, to be evaluated separately at an arbitrary moment in time. The entity was thus redefined as a legal-economic vehicle designed to be employed by investors active in benchmarking financial markets to hold such assets and liabilities (Biondi 2011).

The effect of this view of accounting has been to rule out any concern with the income generated over time by the enterprise entity as a whole. In this financialised approach, the collective, dynamic dimension of the enterprise has lost its central status. Accordingly, regulators started issuing specialised accounting standards for each distinct accounting item. In doing so, they are rejecting more than a century of progress in accounting theory and regulation. It should be stressed that the conceptual frameworks underpinning the work of the US and International standard-setting bodies do not have a "constitutional" character—in other words, they cannot be used in practice, nor can they serve as a reference for application of the standards when preparing financial statements. Each specialised standard has its ad hoc validity; there is no requirement to refer to key foundational concepts. Moreover, their sets of standards contain no clear definition of the enterprise entity, while standards are typically applied on a case-by-case basis, transaction by transaction, and thus independently of each other.

This amounts to a genuine revolution that creates a whole series of problems. This chapter shall attempt to deal with them in historical perspective, drawing three lessons that I will present in a somewhat provocative manner:

The first lesson is that the enterprise should not be equated with the market.
The second lesson is that fair value is not accounting.
The third and final lesson is that accounting should not take its lead from the market; the market should take its lead from accounting.

1) The enterprise should not be equated with the market

If the enterprise were the same thing as the market, the market viewpoint would prevail and market forces would be omnipresent, determining all types of transactions and economic activities. This is simply not the case, however. Strictly speaking, on the one hand, there are share market prices and a financial investment logic that should be part of how the value of a listed company is estimated. This is the task facing investors, at least so-called fundamentalist or long-term investors active in financial markets. On the other hand, the accounting system defines and tracks corporate performance achieved over time, as transactions are completed and the potential becomes actual. This is a logic of control, of accountability; it is also the management logic that any enterprise needs to be able to function over time and to address a wide range of matters spanning industrial organization, finance and economic relations with stakeholders, both investors and non-investors.

Seen in this light, accounting information should complement market information rather than following it (Biondi et al. 2012a). On the one hand, you have the market with its price system, which generates market information through interaction among investors, each having only limited and dispersed knowledge. Just how relevant and trustworthy such market information is will depend on the state of the market and the opportunities for market participants to access firm-specific information. On the other hand, you have an enterprise entity that is fundamentally distinct from the market and that cannot be comprehended without genuine accounting information, which provides the critical firm-specific knowledge that is common knowledge among investors.

In summary, two systems of information, representation and control are required and present, rather than just one (Biondi 2003, 2010): the accounting system and the share price system.

2) Fair value is not accounting

This brings us to the second lesson from history: fair value is not accounting. If you go back and reread the classic accounting scholars, the ones who wrote before the new wave of financial economists inspired by modern financial theory, you observe that they provided a critique of the idea that company accounts should include profit and loss estimates, i.e. a whole series of valuations guessing on transactions that may never be realized (including Savary 1675). Recent authors like Ijiri (2005) have echoed their concerns in a theoretical debate that is far from over today.

Yet fair value requires such estimates. It portrays the enterprise as a collection of disparate resources that are assumed to be liquid, given that they can be measured at their current market value or by using mark-to-model estimates of that value (Biondi et al. 2008; Biondi and Fantacci 2012). Estimates of this kind thus result directly from a view of accounting as an instantaneous valuation system, with markets supposedly providing the most reliable indication of business value.

Needless to say, this approach subjects the enterprise to the market, whereas the corporate performance can only be produced over time, and with the involvement of the whole enterprise (Biondi 2011). In any enterprise, the outcomes of the various processes, activities and segments overlap and offset each other. That, in fact, is part of the rationale for creating complex enterprise groups spanning several industries and several countries (Strasser and Blumberg 2011). This highlights how regrettable it is to disregard the enterprise entity as a whole that generates corporate income over time. The firm as an integrated entity and going concern should indeed be the focus of any accounting model. In the older accounting paradigm, the principle of the firm as an enduring economic entity was universally recognized and upheld in all countries and regulatory contexts (Hoarau 2006). It follows that there was no need to displace this principle to achieve international accounting harmonization. The reasons for this displacement must therefore be sought elsewhere—in the financialization imposed on corporate activity and accountability.

3) Accounting should not take its lead from the market; the market should take its lead from accounting

This brings us to the third lesson from history. Should we accept the new role assigned to accounting or stick to the old one? The traditional accounting paradigm serves to remind us that the firm is an enterprise entity located in space and time, an enterprise entity fundamentally different from the market. This paradigm distinguishes between and matches cost and revenue streams, instead of lumping them together in discount-based present value estimates. Furthermore, the older model does not entail a net loss of information for investors, because it avoids the use of fanciful profit prophecies, and the application of discount rates that introduces further forms of pro-cyclicality, due to the movement of interest rates used as benchmarks. In this way, a genuine accounting logic emerges. Rather than seeking to achieve the impossible estimate of enterprise value (in the form of market or discounted value), this accounting logic focuses on economic and financial flows in a relevant, reliable representation of invested costs and accrued revenues generated over time by the enterprise as a whole. This historical accounting logic, along with the information it provides, can contribute to smooth price formation in the financial market and be useful to investors, financial analysts and other stakeholders concerned with ongoing corporate affairs (Biondi 2003; Biondi and Giannoccolo 2015).

2 Examples from the International Financial Reporting Standards

The cases of intangibles and goodwill, as well as that of financial liabilities, are significant to comparatively assess the distinctive perspectives of accounting under examination. Take the example of the financing of core R&D expenditures. According to the financial logic (fair value), these expenditures do not constitute separable assets that are disposables at and valuables through their current value. Therefore, the underlying intangible resource is not a corporate asset, financially speaking. However, traditional accounting logic does dissent. Useful resources, be they financial or productive, may never be disposed without losing all the synergies resulting from their combination, and the conditional competitive advantage that fosters corporate income generation. Therefore, the underlying intangible resources may be represented as intangible assets by capitalizing and amortizing related expenditures over time (Ijiri 1975; Biondi and Reberioux 2012).

The case of goodwill generated through business combinations is also significant. According to the financial logic (fair value), goodwill is generated by the difference between the transfer consideration and the sum of revaluated net assets. In this way, the transfer consideration is assumed to be the best evidence of the value of the acquired business; accordingly, goodwill becomes an indefinitely durable asset, only submitted to impairment tests for depreciation. However, the accounting logic does dissent. Transfer consideration occurs under peculiar, exceptional circumstances that should be checked against accounting evidence. As a matter of history, goodwill was distrusted (Ding et al. 2008) and quickly written off (or at least amortized over time), while the pooling method of accounting was allowed to treat all cases where no arm's length transaction occurred in the business combination.

In case of financial liabilities, fair value accounting recommends to account for them at current market prices whenever available, or an estimated value mimicking those market prices. The business entity is then supposed to be a portfolio of accounting elements, be they assets or liabilities, which all are marketable at will. This entity is supposed to hold financial liabilities, not owe them to someone else. However, the accounting logic does dissent. As matters of fact and law, the business entity has entered financial transactions which involve explicit or implicit financial obligations that must be fulfilled in near or remote future according to their terms and conditions. These obligations can be formalized in transferable securities such as shares and bonds, but also consist of obligations with employees, suppliers and fiscal authorities. From this perspective, their possible buy-back involves a distinct financial transaction that is unrelated to their recognition as an advance on future cash inflows generated by the enterprise entity. This advance corresponds to a series of future cash outflows that are expected to become due to the holding stakeholder in the future.

3 Reconciliation of Accounting and Finance

Without paying attention to the legal-economic congeries of the business firm and its specific economic environment that is fundamentally different from the market, the financial reporting paradigm bears the huge risk to advertise self-standing declarations of financial value by management, instead of providing trustworthy summaries of corporate performance and position generated over time.

From an historically grounded perspective, at least two points are fundamental to reconcile accounting and finance: a comprehensive view of accounting as an epistemic, organizational, and institutional device; and the recognition of its special role in the dynamics of Share Exchange as common knowledge of reference, available for subjective valuations and decision-making (Sunder 2002).

First of all, the relationship between accounting and the share market should not preclude accounting's role as a mode of organizing, regulating, and representing the activities of enterprise entities through time. The accounting system has performed and should go on performing multiple functions in economy and society: not only the disclosure of accounting information (including for the share market), but also the construction of operational costs and managerial indicators of performance, and the regulation of dividends, business income taxes, prudential ratios and other institutional matters. Here accounting is understood as a common language (and knowledge) of business (epistemic role), a managerial instrument (organizational role), and a fundamental mode of governance and regulation (institutional role). All together, these roles of accounting embed the working of accounting systems at the intersection between socio-economic and financial systems.

Accordingly, accounting may be expanded following to its own accounting logic. At least three suggestions emerge from the traditional view (Biondi 2011). Concerning the assets side, accounting systems may capitalize invested expenditures on R&D as depreciable assets, according to conventions disclosed by, or even shared among firms (Lev and Zarowin 1999). Although accounting cannot estimate intangibles' value (nor the market can), it may report on actual investments that the management has committed to them. Concerning the liabilities side, accounting systems may recognize the cost of shareholders' equity (Anthony 1983), as financial economic theory does with the "time value of money". Shareholders' equity constitutes a special source of financing for the enterprise entity (Schumpeter 1912; including first English translation of neglected pages in Biondi 2008b): it is then a special liability whose accounting cost may be based on the funds that have been actually provided over time. Concerning business income determination, accounting systems may distinguish unrealized capital gains and losses from operational incomes and incurred costs, in order to avoid standardizing "Ponzi-schemes" among different stakeholders over time (Biondi 2013).

4 Concluding Remarks

In the last four decades, an accounting revolution has pretended to develop accounting as a form of financial reporting, including on potential capital gains. However, past accounting traditions had already understood that accounting is not as primarily about communication as control. Accounting is concerned with cash and non-cash resources committed to socio-economic entities. It establishes then norms, rules, and processes to control, organise and regulate these entities and the related resources in situation. To achieve this purpose, past traditions had based accounting upon the representation of the business firm as an enterprise entity (also called 'going concern' in English, 'Betrieb' in German, and 'azienda' in Italian), that is, a becoming collective entity that evolves over historical time and socio-economic space.

By taking the business firm as their central concept, past accounting traditions had avoided another modern mistake that consists in imagining that only 'markets' stand out in economy and society. However, economic and social relationships cannot be limited to a pervasive price system. 'The' market is not the only (or the one best) way to organise and coordinate economy and society. Actually, whenever markets exist, they work in very different way from what some expect and day-dream. It is somewhat astonishing that 'positive' and 'empirical' researches in accounting have been scarcely concerned with the ways in which markets do factually work, preferring to rely on their own alleged assumptions about market working. As a matter of experience, business firms and institutions exist and function together with markets. Embedded in this broader socio-economic context, accounting system cannot be reduced to a price system. The latter relates to the market as the former does to the business firm, both being distinctive modes of economic organisation and coordination.

Leading scholars of past accounting traditions were often outstanding professors in leading universities; they worked in close connection with major companies and regulatory bodies; they educated professional accountants and helped developing the first accounting model that was globally harmonised: the model of historical cost accounting. The financialised model of nowadays accounting, which is emerging since the 1970s, was not the first attempt to harmonise accounting throughout the world. From an historical perspective, historical cost accounting was accepted by and adapted to most accounting traditions and jurisdictions around the world. Actually, these local variants of the past accounting model were surely less important than both options that are still available in international financial reporting standards, and carve-outs that those standards generate as a reaction to international generally imposed accounting rules. The concept of an accounting representation of an enterprise entity situated in time and space and bearing social responsibilities had been shared by most accounting systems throughout the world. Nowadays, some divergences and carve-outs from international accounting standards may actually depend on resistance and confusion generated by the market-based view of the business firm that those standards drive and impose.

This market-based view relates to the new financial reporting paradigm that has driven accounting into a dead end. Just how badly it has failed is highlighted by recent scandals and the shortcomings revealed by the global financial crisis. Nor should anyone forget that emergency intervention by treasuries and central banks were required to save many of the banking and financial institutions, which were the most subject to the new fair value model. We should drive all the relevant implications on the economic consequences of this model from this natural experiment (Bignon et al. 2009).

To get out of this dead end, we need to make a few basic observations and lay the theoretical groundwork for an acknowledgement of the role of accounting as a mode of representing, governing and regulating business activity that provides relevance and reliability for all stakeholders, including shareholders. An enterprise accounting system fulfils a variety of functions in business and society. It provides information to shareholders (including investors in the share market), while also helping to measure production costs and operating results and to regulate dividends, taxes, prudential ratios and the like. Although this is only a statement of fact, it further paves the way toward a redefined purpose or underlying principle of accounting standardization that may still provide investors with firm-specific information. As for such a common source of accounting information on corporate performance achieved over time offers financial analysts and investors a lighthouse for validating their valuations and expectations. Investors may then be constantly reminded that they are investing in an enterprise, and not just in a supposedly liquid financial security (i.e. one that they can sell on the market at any time). The losses triggered by scandals and financial crises offer just this kind of reminder, but only when it is too late.

The time has come to impress upon financial analysts and investors that, by investing in enterprises, they are exposed to the risks and hazards inherent in the activity of those enterprises. It follows that they, too, need a common, shared, reliable source of information that trustworthily represents the performance of each enterprise entity over time in situation. It is only on the basis of this performance that they can form objective, realistic valuations and expectations. Accounting, therefore, should not be responding to the market; the market should rather be responding to genuine accounting information.

Acknowledgments Yuri Biondi is research director and executive committee member of the Financial Regulation Research Lab (Labex ReFi), ESCP Europe, 79 avenue de la Republique, Paris 75011, France (http://www.labex-refi.com/). A previous version of this chapter was read at and included in the proceedings of the 'Second Symposium on Accounting Research' organised by the Autorité des Normes Comptables (ANC), Paris, 16 December 2011. The current version further draws upon our "Accounting and Business Economics: Understanding the Past to Face the Present and Prepare the Future", published as chapter 18 (pages 485–492) in Y. Biondi, S. Zambon et al. (2012), Accounting and Business Economics: Insights From National Traditions, London and New York: Routledge.

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