***Accounting, Economics and Law of the Firm as an Enterprise Entity***

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# Abstract

For those concerned with the nature and role of the firm in economy and society, these are challenging times. The scandals surrounding the failures and shortcomings associated with Enron, WorldCom and many other corporations have focused attention on accounting, governance and regulation policies in a way many may never have imagined and few welcomed. As many scholars have recently acknowledged, reforms are necessary, to protect shareholders and other parties.

The idea of the firm as an enterprise entity implies a comprehensive approach that integrates economics, accounting, and law. A new perspective appears to be required to challenge received doctrines and to promote a better understanding of the firm. We seek to comprehend the firm as a managed dynamic system, characterized by different structures of production: institutional, organizational or epistemic (related to the nature and role of institutions, internal organization, and knowledge within the firm).

Accordingly, the accounting system may constitute a field where the view of the firm as an enterprise entity demonstrates the joint implications of economic, accounting, and legal matters. In a world featured by real dynamics and complexity, the accounting system copes with the economic and monetary processes generated by the whole enterprise, and deals with the representation of business capitals and incomes. It constitutes the mode that allows this special process to exist and to function autonomously from and interactively with external markets or institutionalised ownership claims. This entity approach has implications for enterprise governance, regulation and accountability.

# Y. Biondi, A. Canziani, and Th. Kirat (2007) eds.
# *"The Firm as an Entity: Implications for Economics, Accounting, and the Law"*
# London and NY: ROUTLEDGE, April 2007

My speech relates to the book published by Routledge last year. This book provided the background for a new theory of the firm based on the synthetic notion of the firm as an "enterprise entity."

The book presents essays by eleven co-authors (from France, Italy, UK, and USA) and reprints of neglected papers by past scholars: R.N. Anthony, A.A. Berle, R. Coase, M. Shubik, H. Simon, and J.H. Stauss.

The "new" perspective adopted implies an interdisciplinary approach with insights from and implications for economics, accounting, and law of the firm.

Book Presentation: http://ssrn.com/abstract=983029

Basic Paper: http://ssrn.com/abstract=774764

# My speech

First, I will present the new view of the firm as an enterprise entity by summarising the book's main points.

Later, I will address two alternative views on the firm, namely the "black box" and the "proprietor entrepreneur", and argue that they are "daydreams".

Finally, the critique of these views will lead to some implications for enterprise governance and regulation.

# I - "The Firm as an Enterprise Entity" in few Words

The book calls for a new perspective providing a better understanding of the institutional, organizational, and epistemic (cognitive) dimensions of the firm.

The book drew upon a "sense of lacking" in the current state of the economic theory of the firm, which is primarily divided among the contractual (new institutional) and the competence-based approaches.

Key suggestions are derived from the contributions by (among others):

- **SIMON**, with his organizational economics approach focusing on firms as dynamic systems,

- **SHUBIK**, dealing with the relationship between accounting and the critique of equilibrium economics (neoclassical),

- **COASE**, exploring the contribution of accounting to the theory of the firm,

- and **BERLE**, criticising the classical view of the proprietor-entrepreneur under the economic and financial conditions that characterize(d) the XX century.

## I - "The Firm as an Enterprise Entity" in few Words (cont.)

The "new" perspective takes inspiration as well from some traditions of thought (from economics, accounting, and law) that have already tried to understand the business firm and its impact on the economy and society, especially:

- The continental European tradition of accounting and economics;
- The older American, *and European*, institutional economics.

Together, these perspectives offer some backgrounds for the view of **the firm as an entity, a whole, a dynamic system**. In particular, such view integrates law and economics with accounting.

The firm is then:

- Understood as an enterprise entity;
- Characterized by a peculiar economic and monetary process (dynamic system), which
- Generates special business incomes to the firm;
- While being confronted with the actual dynamics and complexity of socio-economic reality (unfolding and undetermined).

The book examined the consequences and implications of this new perspective for accounting, ontology, law and economics, business finance, and the governance of the firm.

## II - Behind the daydream of the "black box"

Let me delve into the fundamental notion of the firm as an "enterprise entity". I will adopt a comparative approach, using two alternative and contrasting views of the firm.

*Once upon a time*… people started to view the firm as a "**black box**".

The study of the history of economic thought would place some light in that box. It would no longer appear to be empty or black, but understood as:

- A shallow *nexus* of (market) prices or (complete) contracts;
- A mechanical link between price and cost for each product separately (*marginal cost pricing*);
- A unique objective of "profit maximisation", a profit that shall result null (Tantalus).

Ask managers of such a firm about their govern and the business incomes generated,
And they may reply:
**What about responsibility or results? The markets did all and everything;**
**We follow the markets**

The firm as such disappears, i.e., it has no impact on the economy and society.

## II - Behind the daydream of the "proprietor entrepreneur"

Another daydream understands the firm as a legal-economic device of its "proprietor entrepreneur". This time, the firm disappears in favour of **the lonely runner of his own business**.

This capitalistic hero takes and bears alone the risks, and alone endorses the whole management of its own enterprise. The firm and its personnel are nothing but his instruments, playing no role in decision-making, organisation, or control, since *all that matters* is the solitary **owner** of the firm.

This viewpoint understands the firm as:

- A form and a part of ownership and wealth;
- A legal and economic device for the solitary owner;
- A unique objective of generation of rents from that wealth.

Ask managers (if any) of such a firm about their govern and business incomes generated,
And they may reply:
**What about governance and results? The owner did all and everything.**
**We obey to the owner**

Once again, the firm as such has no impact on the economy and society.

## II - **The problems with these daydreams**

However influential and significant these daydreams are, they involve problems that factually go beyond the emotional reactions for or against themselves.

These views do grapple with the reality of the business firms as they exist and function in the economy and society (today, at least):

- Firms combine a number of corporate and other legal arrangements (including contracts and regulation concerned with labour, financial security, foods & drugs, environment, anti-trust);
- Firms face the “separation of ownership, management and control”;
- Firms maintain accounting systems as a mode of looking inside their enterprise process.

Let me point out some distinctive facts.

## II - **The problems with the "proprietor entrepreneur"**

Contrary to the "proprietor entrepreneur" viewpoint, law and accounting tell us about the functional distinction between the firm and its "owners":

- The legal structure of the firm integrates several legal forms that hold and possess the assets, enter into contracts and obligations, have priority rights in flows and results;
- Prudential regulation (through the accounting system) restricts dividend payments and equity repayments from the firm to shareholders or partners;
- Fiscal regulation (through the accounting system) establishes the tax basis on the net earnings generated on the period.

Then, **ownership by isolated individuals** is framed and shaped by a "phantom" entity that the idea of a "solitary owner" does not cope with.

## II - The problems with the "black box"

According to the "black box" view, the price system is sufficient to understand, organise and regulate the business activity. Business firms are neutral and institutions do not matter.

No business inflows and outflows exist but market prices.

However, **the firm (and its dynamics) matter** in the economic and monetary process. In particular,

The **accounting system** defines revenues and costs of the period, and, on this basis, determines the net earnings that may be distributed to shareholders (whilst determining the tax basis, maintenance of prudential ratios, executive compensation, and so on);

This way, the accounting system provides a **common representation** of business capitals and incomes to the firm.

This accounting representation is concerned with the dynamics of the firm, which **implies price formation, carried immobilizations (investments), overhead allocation**, and all the concerns which lay at the core of everyday business activity.

## II - The Firm as an Entity and its Accounting System

The accounting system copes with this **special process of becoming,** by accounting for the firm *as an entity*.

The entity's process is concerned with uncertainties, bounded knowledge, potential and actual mistakes, and mis-organisation. It is then *unfolding* and *undetermined*.

In this context, the accounting system becomes a special *mode of regulating, organising, and representing* the economic organisation and its becoming.

Contrary to the black box, the firm is not a simple "nexus of monetary flows", since the accounting system goes beyond this cash basis through its definition and application of "accruals". This way:

- The firm and its accounting system are not simply a "nexus of market prices", whilst
- The accounting system becomes a constitutive part of the "institutional structure of production", which can no longer be reduced to "property rights" alone.

**Finally, the firm as an entity and its accounting system play an active role in the enterprise process of creating and allocating resources (production and distribution of wealth).**

## III - **The Governance of the Firm as an Enterprise Entity**

We are ever free of thinking that firms *should* be dominated by either markets or owners. Actually, this is the main attitude in the last three decades of governance and regulation.

A theory is not only concerned with *what is* and *should be*, but also with *what can be*, i.e., it provides an understanding of facts and potentials. This overall understanding is fundamental whenever recommendations are expected. Otherwise, poor public policies may result (as recent shortcomings testify).

Even if we decide to neglect the firm *as such*, it will still be **the field of overwhelming power**.

And the firm, as a phantom, may go on haunting the socio-economic realm. We know from scandals and recent crises how much that phantom can be mean.

The new perspective takes the firm seriously. Let me introduce some consequences and implications of this view for the governance of the firm as an enterprise entity.

## III - **Implications for the Governance (and Regulation) of Business**

According to the view of the firm as an enterprise entity, we upgrade governance and regulation from a *logic of ownership and markets* to one of accountability.

~~Property rights~~ ➔ Accountability (including accounting system) ⇔ institutional system (structure)

In particular, the accounting system becomes a mode of making the firm accountable, whilst the firm itself is recognised as a special field fraught with asymmetries of resources, access and control.

The firm's field implies key *dynamic and comprehensive concerns* that cannot be addressed at the individual or the contractual level. Price formation, carried immobilizations, overheads allocation distinctively feature this field through continuity and change.

The institutional structure of the firm (including its accounting system) enters this uncomfortable field as an accountability device. The enterprise entity view has here five main implications:

1. The entity may be understood as a joint "becoming concern", autonomous from stakeholders (including shareholders);
2. The separation between ownership, and control, *and* management;
3. The impact of "absentee ownership" (and the difference between the legal and economic frontiers);
4. The role plaid by the accounting system in the enterprise process;
5. The articulation between this process and the value (and valuation) of equity shares.

## (Point 1) The Entity is a joint becoming concern

(1) The economic autonomy and continuity of the firm as a joint *becoming concern* are defined (among others) by some legal features:

- Shareholders' limited responsibility and unconstrained "exit";
- Prior legal protection granted to other stakeholders rather than shareholders in some cases;
- The legal capacity of the entity to enter contracts and obligations (by means of companies and mandates and other legal forms and devices);
- The entity's autonomous (collective) property and possession of assets, and priority in the control of cash flows, incomes and results.

# (Points 2 and 3) Property, control, and management

(2) The separation between, on the one hand, ownership, and, on the other hand, control *and management* (namely possession). Only the latter is entitled to dispose of assets and flows and organise the overarching activity.

(3) The impact of « absentee ownership » (Veblen), i.e., the large number of shareholders holding a small part each of the shareholders equity value, and being excluded from decision-making (**AGLIETTA & REBÉRIOUX**), whilst large minority shareholders factually control the firm, and enterprise groups feature the financial scene (**STRASSER AND BLUMBERG**).

Legal frontiers (forms) are distinct from economic frontiers (substance).

# (Points 4 and 5) Accounting system and the value of equity shares

Some accounting matters:

(4) The accounting system provides relevant and reliable figures to the institutional constraints on dividend payments and repayments of shareholders' equity. Furthermore, net earnings can be and usually are retained as sources of « financing ».

(5) Before liquidation, the entity does not have to repay shares at their value (either market or accounting value). Shareholders must sell them on the stock Exchange in order to recover their investment.

## III - **The enterprise entity and the shareholders' claims**

According to the (narrow) definition of Shleifer and Vishny (1997: 737):

"*Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*"

The authors imply either of a market return, or a comprehensive return including dividends.

**However:**

- The market value is external to the enterprise process (point 5), and

- The distribution of dividends is residual and constrained by the figures established by the accounting system (point 4).

# III - **The enterprise entity and the shareholders' claims (cont.)**

Take the viewpoint of the enterprise entity: The shareholders equity constitutes a special source of financing (Schumpeter).

Accordingly, the accounting system may recognise the shareholders' claim on the business incomes generated by the enterprise entity as a cost and an allocation.

Several ways are possible: for example, by defining a "shareholders' equity interest" (Anthony) *based on the actual financial funds provided in the past*, or by settling the shareholders' share (interest) of the overall net earnings (as the German code does).

Ask managers of the firm as an entity about their govern and the business incomes generated,
And they may reply:
**Under our fiduciary responsibility, the firm has generated the results accounted for by the accounting system, and partly allocated to its shareholders.**

A further accounting system for *sustainability* may be developed, to provide a more comprehensive approach to the accountability of the business affairs (environmental and societal issues).

# Summary and Conclusion

In summary, a new transactional and institutional perspective is required to better understand the firm as an institution and an organization having a distinctive impact on the economy and society.

This perspective implies a new inter-disciplinary approach, linking Economics, Accounting and Law by a unique common notion: the firm as an enterprise entity.

This further development is original, but is not isolated in the current debate:

- Especially Baker, Gibbons and Murphy speak about the management of off-contractual relations to understand the firm,
- and also Rajan and Zingales are concerned with the integrity of the whole firm against the "dark side of the ownership" (they say).

The enterprise entity is understood as a whole, *a dynamic system of relationships*, not only contractual or bargaining:

- From this perspective, both order and disorder, efficiency and waste, honesty and guile, development or distress have much to do with the structures of such relations (more than what existing theories have already recognized).

- The accounting view of the firm as an entity provides valuable insights to better grasp (i) the inner economic nature of the firm, (ii) the separation between ownership, management, and control, and (iii) the governance of the firm.

## Main References

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## The Firm as an Enterprise Entity