Accounting system and the representation of the business Firm as an Entity

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Here are the slides supporting my speech.
The related paper is forthcoming as working paper in the official series of University of Brescia (Italy), next July 2005.

Please check my web page to download it soon:

http://yuri.biondi.free.fr/

Abstract

The box that neo-classical theory designs for the firm does appear neither black nor empty. The skeletal machinery built on *marginal cost pricing* ought to grasp the economic and monetary process inside the firm, at least in its fundamental elements and results. It aims at explaining therefore selling price, cost, quantity, and resultant (no) profit for each product separately. This machinery, moreover, allows the price system alone to dominate the firm, at least from the economic viewpoint, when creation and allocation of resources are concerned.

Following Coase, Shubik and Simon, instead, the inner working of organisation and of the accounting system is on the new agenda for understanding how the special economics of the firm *supersedes* the price system.

This paper seeks to further develop this issue, exploring the accounting system, its nature and role in the special economics of the firm. Accounting system constitutes the "veil" that allows the special economic and monetary process of the whole firm to exist. By means of the accounting system dealing with the business incomes to the firm, this special process acquires autonomous but interdependent existence from external markets (both from factors or products markets), and the becoming economic *activity* of the firm *as an entity* is more clearly recognised.

In this accounting-based transactional and institutional perspective, the firm-entity functions and exists as a *managed dynamic system* characterised by different structures of production, institutional, organisational, or epistemic (related to the nature and role of institutions, internal organisation, and knowledge in the firm). Accounting system becomes a constituent part of these structures and of the whole firm. This new perspective opens to an interdisciplinary approach linking Economics, Accounting, and Law by the shared, synthetic notion of the firm as an entity, which provides the "clue" for understanding the nature of the firm as a whole.

Summary

Why delve into accounting to understand the nature of the firm?

In the first part, I will present some recent suggestions of Coase and Shubik calling for exploring the relationship between **accounting and the nature of the firm**.

In the second part, I will try to explain how and why **accounting** provides a special **view** of the firm that Economics should integrate. This view is especially concerned with the economic and monetary process generated by the firm.

In the third part, we will see how this accounting view offers further implications for a new theory of the **firm as an entity**.

I-a) The "new institutional revolution" fostered by Coase…

The new theories of the firm have been fostered by the new understanding provided by Coase:

- of the nature of the firm, and
- of the role of "institutional structure of production".

Following the price system economics, **institutions** are relegated to an exogenous framework. This framework does not play any active role in the economic and monetary process. Entities are neutral (just black boxes) and institutions simply do not matter.

Accounting also has been neglected for a long while, relegated at the margin of this process. Just like all the other institutions, **accounting did not matter**.

The "new institutional revolution" fostered by Coase deals, on the contrary, with the opposite idea: **institutions matter** and the firm must have its special economics, alternative and complementary to the price system. According to Coase, we have to deal with the three following issues:

(a) the economic distinction between the firm and the market, i.e. how the firm *supersedes* the price system;

(b) the *active* role of (legal) institutions in the special economic process generated by the firm;

(c) and the inner working of organisation and of **accounting system** as key tools for this special economics of the firm.

I-b) …and the Coase's calling for Accounting and the Nature of the Firm

In his "classic" on the nature of the firm (Coase 1937), Coase characterises this nature as direction of resources (especially employees). He makes the following distinction between market transaction and the firm.

By one side	⇔	*by another side*
MARKET TRANSACTION (*BUY*)		**ENTREPRENEUR-FIRM (*MAKE*)**
marketing costs, costs of using the price mechanism	⇔	*decreasing returns to the entrepreneur function*

In more recent papers (Coase 1988 and 1990), the firm is understood as management (running the business), dealing with the range of products sold; price policies; structures of internal organization

By one side	⇔	*by another side*
MARKET		**FIRM**
price system	⇔	*accounting system*

In this context, I wish to link accounting to the "institutional structure of production" (Coase 1992).

I-c) Accounting against equilibrium framework: the Shubik's insight

In a neglected paper, Shubik (1993) also calls for exploring the role of accounting in the economic and monetary process.

In particular, he contrasts the equilibrium framework provided by the price system with the accounting view concerned with real dynamics and uncertainties.

In the spirit of Coase and Shubik, a new transactional and institutional perspective should delve into accounting as a mode of looking inside the firm to grasp its special economic process.

In fact, these scholars give us the idea but they do not develop it further.

In my opinion, accounting system can provide an original understanding of the special economics of the firm. It may constitute the "veil" allowing the firm to *supersede* the price system, since:

- Accounting deals with the **firm as an entity**: Business activity is seen as a dynamic concern and accounting system has to report on it.
- This reporting is especially concerned with the representation of the **business income to the firm** (so-called earnings). It is for this income the entity is *accounted for* (accountability).
- Accounting system, therefore, becomes **a mode of knowing, organising and regulating** the economic and monetary process belonging to the firm as an entity.

II-a) The Accounting Principles

Then, this second part of my speech explains how and why accounting provides a special view of the firm.

The accounting representation of the firm is based on some **accounting principles** (GAAP) we can synthesise in the following:

(I) The business firm is an **ENTITY**, autonomous from whichever stakeholders (including shareholders).

(II) A special method to link economic and monetary entity's streams to the reference period.

(called **MATCHING PRINCIPLE**)

(III) A special method to recognize and estimate actual business activities as assets and liabilities, costs and revenues.

(called **HISTORICAL OR INVESTED COST PRINCIPLE**)

These principles were and still are in question, but they are, at the present, the principles generally accepted to represent the firm by accounting[1].

They constitute the accounting view we are looking for.

[1] On recent developments, cf. V. Bignon, Y. Biondi, and X. Ragot, *An economic Analysis of fair value: The evolution of accounting principles in European Legislation*, with a commentary of R. Barker (Cambridge University, IASB Scientific Committee) and a rejoinder of the authors, *Centre Cournot pour la recherche en économie*, Prisme n. 4, mars 2004.

II-b) The accounting view of the nature of the firm

Let me delve into the foundations of these accounting principles. Quarrels about them relate (also) to the special view of the firm these principles imply.

As recognised by leading accounting theorists (Zappa, Schmalenbach, Littleton, Ijiri, Anthony), the accounting view deals with the firm as an entity and with its events, resources, and transactions in real dynamics.

This entity's real dynamics implies uncertainties, bounded knowledge, potential and actual mistakes, and mis-organisation.

Real dynamics, therefore, inscribe the firm's business activity into a special process of becoming, and accounting has to represent this entity's process.

As for the accounting view represents the economic and monetary process of the firm in a very different way the equilibrium framework does:

Table II	ASSETS	LIABILITIES
equilibrium framework	future monetary **entries** discounted	claims on future monetary **exits**
accounting view	actual monetary **exit** (expenditure) capitalised	advances on future monetary **entries** (concerned with real dynamics)

Accounting assets, for example, relate to specific financial **exits** (called expenditures) that accounting rules capitalise, instead of entries discounted.

These assets *hold up* the firm-entity as a whole in an *irreversible* way, since expenditures might never be recovered by future selling revenues.

II-c) The entity view overcomes the old-fashioned proprietary view

Furthermore, by the entity view, accounting recognizes the separation of ownership and control.

In the context of modern corporations, that constitute the legal bundling for the modern business entities, not only ownership and control are separate, but ownership and management also (**BERLE**).

In such a context, accounting has chosen to refer to the entity view and principle, instead of the old-fashioned proprietary view (dominating the Nineteenth Century):

Table III	**INCOMES**	**ASSETS**	**LIABILITIES**
proprietary view	rents or quasi-rents	properties	claims and rights on properties
entity view	business income to the firm (based on actual revenues and costs)	costs invested	revenues advanced (concerned with real dynamics)

Even so, some economists are still thinking of the firm in terms of the irrevocably lost *ownership sovereignty*…

…and we know their troubles with the *separation between property, management and control*…

In fact, their perspective is made for *poor public policy*, as the recent crises in corporate governance also testify.

II-d) Accounting system and the "institutional structure of production"

In summary, at least the following three points **distinguish the accounting system from the price system**:

(a) First**, accounting system is accruals- and not cash-basis**, it grounds on financial transfers and not only on cash (so a « veil » exists between each monetary price and the internal economic process);

(b) Then, accounting system, with its special mode of regulating, organising, and representing the firm (related to overheads, accruals and other accounting values), further **modifies the economic and monetary process** of the firm-entity;

(c) Finally, as consequence, accounting system **provides relevant figures to *active* legal rules**: (i) constraining dividends if they might damage the firm as an entity, and (ii) asking to pay **taxes** on the special income generated by the entity itself.

In conclusion, the accounting system becomes a constituent part of the "institutional structure of production", which we can no more reduce to the *property rights* alone.

The firm as an entity and its accounting system have an active role in the economic process of creating and allocating resources.

Indeed, Entity and Accounting can explain in an original way the economic nature of the firm.

III) Implications for a further theory of the firm as an entity

In summary, a new transactional and institutional perspective is required to better understand the nature of the firm and its role in the economic and monetary process (as suggested by Coase, Shubik, **SIMON, …**).

This perspective implies a new inter-disciplinary approach, linking Economics, Accounting and Law by a unique common notion: the firm as an 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 firm-entity is understood as a whole, a **dynamic system of relationships**, not only contractual or bargaining.

- In 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 way the firm *supersedes* the price system, and (iii) the separation between ownership, control and management.