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## **“Governance and Disclosure of the Firm as an Enterprise Entity”**

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## **My speech**

**First Part** – The revival of ownership and market views on corporate affairs

**Second Part** – The theory of the firm as an enterprise entity

**Third Part** – Better accountability for shareholding and sustainability

→ **Published Article:** Seattle University Law Review (2013)

## I – Revival of ownership and market views on corporate affairs

Recent drift toward shareholders' primacy has surely driven a coming-back of proprietary and market views on corporate governance and reporting:

- Shareholders would be “owners” of companies, which should maximise share market value
- Managers should act as “trustees”
- Companies should become good “citizens”
- Corporate transactions are at ‘arm’s length’, framed by markets.

These views refer to the business firm as a financial trust to be managed on behalf of its owners, and to the personification of the legal entity that makes it insulated from social control of business.

(Financial) Markets would be sufficient to enforce fairness and the general interest.

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

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

- **Enterprise Groups:** 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 property, management and control**”;
- Firms maintain **accounting systems** as a mode of looking inside their enterprise process.

## II - “The Firm as an Enterprise Entity” in few Words

The theory of the firm as an enterprise entity takes inspiration from traditions of thought (from economics, accounting, and law) which have already aimed to understand the business firm and its impact on economy and society, including:

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

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

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 have been characterizing firms since the XX century.

## II - “The Firm as an Enterprise Entity” in few Words (cont.)

Especially Berle argues for:

- Power without property
- Corporate revolution: the enterprise entity as an object of law
- Separation between investors (having limited liability) and the business firm

The firm as an enterprise entity is then:

- Understood as an enterprise entity;
- Characterized by a specific economic and monetary process (dynamic system), which
- Generating specific business incomes to the firm;
- Featured by collective and temporal conditions (asymmetries, ignorance, change, and hazard).

To delve into the fundamental notion of the firm as an “enterprise entity”, I will adopt a comparative approach, using three alternative and contrasting views on the firm:

- ✓ Market view (black box)
- ✓ Proprietor entrepreneur
- ✓ Legal person

## II - Behind the daydream of the “black box” (market view)

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

*Once upon a time...* people started to view the firm as a “**black box**”.

The firm is understood as a nexus of contracts, of **arm’s length transactions**, framed by markets.  
Study of 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 policy 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” (The Investor)

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.

*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 policy 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 - Behind the daydream of the “legal person”

A last daydream understands the firm as an artificially created (legal) person having its own life, including citizenship rights, like any other citizen that is a human being.

This time, the firm disappears in favour of the **Frankenstein incorporated**.

This self-serving Giant runs the business in a pure world of law, and *all that matters* is the solitary **legal person** artificially incorporated by law or statute.

This viewpoint understands the firm as:

- A self-standing holder of ownership and wealth;
- A self-serving owner;
- With a subjective objective of whatever the legal person wants, under law or statute.

Ask managers (if any) of such a firm about their policy and business incomes generated,

And they may reply:

**What about governance and results? The legal person did all and everything.**

**We obey to the legal person**

What about its social responsibility? Is the corporation an “island of absolute power”?



## 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 them.

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

- **Enterprise Groups:** 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 through time.

Let me point out some distinctive facts.

## II - Problems with the “proprietor entrepreneur” (the investor)

Contrary to the “proprietor entrepreneur” viewpoint, law and accounting tell us about the functional separation between the firm and its alleged “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 accounting systems) 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 during 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.

Therefore, the enterprise entity can be and has been regulated as an object of law under the law, autonomous from its constituencies, as a going concern.

## II - Problems with the “black box” (market view)

### *Price system*

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.

Every payment goes along with an **arm’s length transaction at market price of reference**.

Market prices would deliver some magic that resolves and reduces all the other dimensions of the firm.

### *Accounting system*

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

- Prices are payments embedded in transactions among parties that must be accounted for;
- The **accounting system** deals with these transactions, while *defining revenues and costs* of the period;
- The accounting system further defines the perimeter of the entity activity:
  - Within the perimeter, non-market transactions and allocations occur through overheads imputation, transfer pricing, debt contracting, and service provision.
  - **At the perimeter margin, insiders can play with related party transactions and special-purpose vehicles...**

## II - Problems with the “legal Person”

Contrary to the “legal person” viewpoint, Republican legal orders establish the corporation (and other legal entities) as intermediary bodies that are *object* of the law. Among others:

- The legal structure of firms comprise (actually, is disintegrated in) a myriad of legal entities and other legal devices which make hazardous to identify that person, even artificial;
- These socio-economic wholes are submitted to a legal order, voluntary and compulsory regulated by consent and the law;
- As legal bodies, they are governed by fiduciary representatives who manage them on behalf of their constituencies, including shareholders (in the case of corporate law);
- They respond and are submitted to a variety of internal and external “checks and balances” to assure their consistent and continued role in economy and society.

In sum, **legal personality** is a convenient legal device (or object) that is framed and shaped by private and public orders; the idea of an artificially created legal person grapples with this fact.

By playing with formal separation of legal persons within an integrated enterprise entity, corporate liability, social responsibility and accountability can be ever circumvented...

### III - Governance and Regulation as artificial orders (social control of business)

We are ever free of thinking that firms *should* be dominated by markets or owners, or even let them be self-regulated as legal persons.

Actually, these have been the main attitudes in governance and regulation for the last three decades.

- ✓ 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 remain **a 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 this phantom can be *mean*.

Imagine if we let it act as a Person!

The Entity Theory takes the firm seriously. Let me introduce some implications of this view for the governance and regulation of the firm as an enterprise entity.

### III - Implications for Governance and Regulation (social control of business)

The Entity Theory upgrades corporate governance and social responsibility:

From a *logic of ownership and markets and legal persons* to one of accountability

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

~~Shareholder value~~

In particular, the accountability (control) system becomes a mode of making the firm accountable.

The firm itself is a going concern featured by collective and dynamic (temporal) dimensions.

The institutional structure of the firm (including its accounting system) enters this overwhelming field as an accountability (control) device.

“Deregulation” has no meaning in this social context.

Governance and regulation are modes of social control of business affairs

In this context, the enterprise entity concept points to its temporal and collective dimensions:

- Continuity over time; going concern principle
- Corporate shield; locked-in equity; corporate management of committed resources
- Inter-temporal and inter-personal allocation of resources
- Commitment by shareholding investors to the ongoing entity activity
- Satisfaction of individual and social needs through satisficing remuneration for resource providers

**Accordingly, we may and should ask not only what the firm does for shareholders and investors, but also what they do for the business firm.**

## **Institutional investors and the firm as an enterprise entity**

These economic autonomy and continuity of the enterprise entity are confirmed by some legal-economic features:

- Shareholders hold limited responsibility, limited liability 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 holds autonomous (collective) property and possession of assets, and priority in controlling cash flows, incomes and results.

**A reasonable way to settle corporate social responsibility is then to balance the interests of shareholders with those of other stakeholders and the sustainable continuity of the business enterprise over time (going concern).**

Ask managers of the firm as an entity about their policy 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.**

This approach paves the way to accounting the enterprise entity for *sustainability*, making business affairs better accountable for environmental and societal issues.

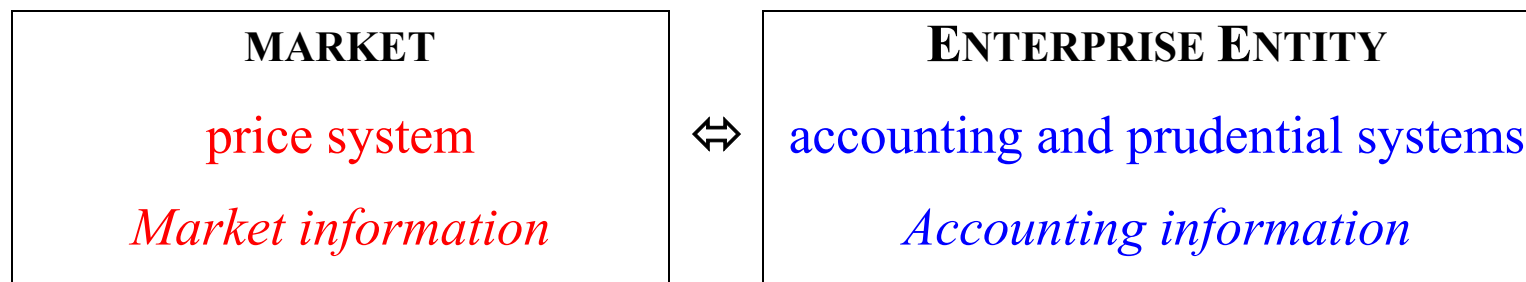
### III – Enterprise Entity vs. Share Market

The Entity Theory disentangles the business firm from external markets of reference.

In particular, business norms and knowledge generated by institutions other than the market play an important role, especially under collective and dynamic conditions.

- ◆ On the one hand, **share prices and the financial market logic** provide estimates of the (potential) profitability of the firm based upon discounting the future for “time value of money.” This valuation aims at estimating the spot value of the business. **(INVESTMENT)**
- ◆ On the other hand, the **accounting system (following its own logic)** provides a reliable confirmation of the (actual) performance *through time*, as long as transactions are completed and the potential becomes actual. **(CONTROL)**

From this perspective, **accounting and prudential regulations complement and do not follow market information.**



This dualistic approach can be applied to improve on market-based corporate and regulatory frameworks.



### III - Summary and Conclusion

A comprehensive approach is required to better understand the firm as an institution and an organization having a distinctive impact on economy and society.

This implies a new cross-disciplinary perspective 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:

- **Blumberg and Strasser** analyse theoretical and regulatory implications of enterprise groups;
- Blair and Stout stress the corporate shield provided by corporate law as a key element of the business firm;
- Stout criticises the myth of shareholder value maximisation;
- Baker, Gibbons and Murphy speak about the management of off-contractual relations to understand the firm;
- Also Rajan and Zingales are concerned with the integrity of the whole firm against the “dark side of the ownership”.

The enterprise entity is then 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).
- ✓ This comprehensive 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) corporate governance and social responsibility.

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