



FINANCIAL AUDIT AS A MANIFESTATION OF INSTITUTIONAL ENTREPRENEURSHIP

Flavian CLIPA¹, Ionel BOSTAN², Raluca Irina CLIPA³

¹ PhD in economics, Romanian Court of Accounts, Department, E-mail: flaclipa@yahoo.com

² Professor, Ștefan cel Mare University of Suceava, Doctoral School of Economics, Romania, E-mail: ionel_bostan@yahoo.com

³ Lecturer, Department of Economics and International Relations, Alexandru Ioan Cuza University of Iasi, Romania, E-mail: riclipa@gmail.com

Abstract *In the rich economic literature on entrepreneurship, the economic, social and normative conditions catalyzing its productive manifestation, we may observe a relative lack of interest for the study of the way in which institutional entrepreneurship replaces specific imperfections typical for formal and informal institutions providing solutions by means of financial auditing to spread the generalized trust in business in society. In this context, our study aims from an institutional perspective to underline that the financial audit is one of the main means used to spread trust in society resulting in the benchmarking of corporate behavior towards meaningful actions stimulating economic growth and development.*

Key words:

institutional entrepreneurship, standards, financial audit

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1. Introduction

Daily reality, as well as numerous studies convince us that different levels of economic development from country to country can be explained only by employing the notion of institutions (in North's perspective – as the rules of the game [North., 1990]) and organizations as actors whose economic behavior is implanted on the pre-existent informal and formal institutional framework.

Therefore, it is useful to distinguish between formal and informal institutions: while a set of statutory regulations may be included into the first category, the second category comprises culture, religion, nation's traditions, etc.

Institutional arrangements in fact represent a solution to existent problems at a specific time in society (DiMaggio, 1988), formal institutions representing the collective actions of society members to eliminate the obstacles based on specific and rational logic that may be understood only by appealing to culture, tradition and customs (informal institutions).

The way these institutional frameworks have been enforced is different. If the formal institutions rely on the legal system, the second category uses social exclusion, tainted reputation, ostracism and opprobrium.

The enforcement of infrastructure contributes in the end to the decrease of transaction costs (Williamson, 1990), contract enforcement costs (as sources of rights and related duties) generating an entrepreneurial

effervescence as the main vehicle of economic development.

So, constructive entrepreneurial behavior will be enhanced by the economic environment in its entirety, an environment structured by a complex set of rules, laws, cultural elements that are extremely important from the perspective of dissemination of business trust among the entrepreneurs (Fogel, 2006).

Constructive entrepreneurial behavior generates economic growth by its intrinsic specificity, risk taking, identification of new opportunities to produce a good at a given level of resource endowment, attainment of X efficiency, supporting high research and development expenses, unemployment stimulation, technical progress dissemination, better use of existent resources.

There are though cases when formal and informal institutions do not work efficiently, not only they do not stimulate constructive entrepreneurial behavior but also direct business towards shadow economy that makes it impossible to spread the effects of growth society-wide. It is the time when the institutional entrepreneurship intervenes into institutional system rethinking and its improvement by legitimizing new standards and implicitly ensuring their adoption by all actors.

It is also the case of international audit standards developed by I.F.A.C. (International Federation of Accountants), a supranational body founded in October 1977 that comprises three million experts and aims to serve the public interest, to strengthen the accounting profession internationally, to contribute to the

development of strong national economies by setting and promoting the adherence to high professional standards, by encouraging the international convergence of standards and by discussing issues of public interest where professional expertise is most relevant.

The financial audit as a manifestation of institutional entrepreneurship assesses the way in which enterprises comply with the standards by presenting realistically the financial performance, cash flows in their financial statements providing undistorted information to final users and contributing to the consolidation of business trust.

The first part of our study will try to emphasize that the institutional entrepreneurship is both an initiative and a method of correcting institutional imperfections by enforcing standards. The second part will focus both on the specific features of these standards (audit standards) and shaping the way in which financial audit ensures the compliance with standards by eliminating partial, unclear and even false presentation of

information included in financial statements and thus generating social gain via business trust.

2. From institutions to institutional entrepreneurship

Institutions may be explained from a historic perspective, they appear due to specific context of a level of economic development trying to respond better to realities of a specific time. For instance, the Industrial Revolution in England had as the main determinant the exigency of social norms that valued honesty, trust, dedication and devotion (Mokyr, 2008).

Institutions often go through difficult evolution, survive for a long time in their primary form and undergo deep changes depending on the way the society as a whole legitimizes their existence. From this perspective, we believe the classification of institutions made by Williamson (2000) and shown in Table 1 is relevant:

Table 1. Classification of institutions

Level of hierarchy	Example	Effect	Frequency of change
In situations associated to social structure of society	Most informal institutions – traditions, customs	Define the way in which society regulates itself	Resistance over time, changes undergone in the last 100-1000 years, even though quick changes may occur due to shocks or deep crises
Institutions associated to rules of the game	Most formal institutions defining ownership rights and the legal system	Define the entire institutional environment	Long-term horizon of actions (10-100 years)
Institutions associated to behavior needed to the game	Rules defining governing and contractual relations	Contributes to the setting up of organization	Mid-term horizon of actions (1-10 years)
Institutions associated to the resource allocation mechanism	Control over capital flows, types of businesses, the system of social insurance	Contributes to regulation of prices and production	Short-term horizon of actions (very short term)

Source: Williamson, 2000: 595-613.

Unfortunately, institutions may be confiscated by the elites, internalized and then transformed into illegal means of insuring the profits. So, let us imagine a legal and court system aimed to support an efficient contract enforcement that would make business partners honor their duties. Contextually, there is a series of private/state enterprises operating in a specific economy. The politicians decided at a certain moment that state enterprises should benefit from subsidy providing fixed profit margins. Due to this fact, such state enterprises/organizations benefitting from the legal infrastructure and a system of incentives may engage in operations blocking competitors by transferring them to the court system even if no

contractual duty was breached. If the lawsuits are long, competitors will incur substantial financial loss (representation expenses, resource allocation to solve the problem and not to identify signs on the market), while the beneficiaries of subsidies may continue their operation undisturbed due to financial resources allotted permanently.

Surely, if we relate to this example, the formal institutions may be substituted by informal institutions – the operations such as those described above may generate the disapproval of other entrepreneurs or the ostracism of individuals involved in such operations. If such informal institutions do not exist or are in their infancy, the entrepreneurs will evolve from productive

to unproductive behavior due to both a mimetic effect and tendency towards undeserved gain when the state rewards counter-production.

The consequences are easy to note – the appearance of a generalized lack of business trust. It indicates that the adoption of specific institutions must precede productive entrepreneurial behavior as institutions allow the right form of entrepreneurship (Boettke, and Coyne, 2009). We should not forget that only the entrepreneur is in charge with the creative destruction of Schumpeter (Schumpeter, 1950), with better use of resources and information existent in society (Kirzner, 1973), with the appearance and dissemination of technological progress.

The institutions appear and develop only if they are socially efficient; many times they are not adopted by all members of society unless they provide a benefit to some of them, so the adoption of specific institutions creates social conflicts. They show a path dependence when they are deeply entrenched into the system of values and traditions and their translation into other values and traditions in the society will end up in their translation into institutions (Boettke and Coyne, 2009: 151-153).

Therefore, culture will play in society the role of a melting pot for future formal institutions choosing which issues the institutional arrangements must address, their shape, the hierarchy of level of importance given to the identified social problems, behavior expected to be adopted by the entrepreneurs. By this process, future formal institutions will reflect the way of expression of informal institutions (Prasad and Elmes, 2005; Redding, 2005).

The quality of institutions, especially of the formal ones (political and legal) channel the type of entrepreneurship due to social incentives that they provide to businesses for the involvement in various activities. Starting from this corollary in a diachronic perspective, Baumol (1990) defines productive and unproductive (or even destructive) entrepreneurial behavior in relation to historic evolution of institutions (rules of the game). Productive activities (innovation, superior use of resources, change of paradigm in management) bring benefits to society generating mimetic behavior among other entrepreneurs, who, for example, starting from an initial innovation of one business may find new combinations and methods in order to benefit from a recent discovery, the technological progress spreading exponentially.

On the opposite end we may find unproductive behavior based on the manipulation of legal and political institutions (lobby, eliminating artificial barriers for industry entrance) that in fact generate profits for some entrepreneurs to the detriment of others.

In terms of negative effects in society, destructive behavior is quite similar to unproductive behavior, in

addition, not only we are found in an entrepreneurial game with a null amount but also there is a pervasive loss for all businesses (for instance, industrial espionage and later technological internalization, patenting a technology that does not belong to the entrepreneur).

Also, the incompatibility of institutions with their objectives and the impossibility of institutions to provide solid incentives to decrease transaction costs generate, as some authors state, a transfer of their own activities to illegal or unreported or informal business sector (Feige, 1990). In a short taxonomy, the illegal economy polarizes the operations generating profit in the illegal business sector (sale of arms). The unreported business operations reflect the profit share of operations (even if they are illegal) that are not declared to tax authorities or are declared at a lower value than the real one.

The amount of the undeclared income may become a barometer of inefficiency of formal institutions at least from two perspectives. Whether taxes are too high making entrepreneurs avoid them, or the compliance with the legal provisions is too difficult due to their workload, deficient classification or the administrative system collecting them. In a study conducted by E.Y. *The Barometer of Romanian Entrepreneurship 2015* replicating a global initiative EY, *G20 Entrepreneurship Barometer*, 49% of entrepreneurs included in the study believe that greatest obstacle they face is not the access to funding but fiscal unpredictability, burdensome fiscal and regulatory system, and amount of taxes.

Briefly, informal economy reflects the behavior of entrepreneurs choosing to complete legal forms requiring the registration of specific operations (for example, civil buildings construction without declaring this type of business or without being a registered legal entity).

As a therapy against the inefficiency of institutional arrangements, institutional entrepreneurship is aimed to change and introduce new forms organization and governing mechanisms due to Schumpeterian alteration of existent institutions. Also, institutional entrepreneurship is responsible for the introduction of new standards whose stability in time will be obtained by legitimizing them with the support of other business operators. (Vosselman, 2010). Their legitimizing appears also when experts from different field participate in their development and dissemination (Jacobsson, 2000) as in the case of international audit standards of I.F.A.C. (International Federation of Accountants), a supranational body comprising a high number of experts. These standards generally contribute to the unaltered transmission of information increasing business trust and implicitly reducing the transaction costs.

3. Standards and audit

As it has already been seen, standards fill up the absence or institutional underdevelopment calling for a set of experts, professional organizations or other people interested in belonging to an institution, who contribute to their wide-spread dissemination legitimization and international adoption until they become a routine or are institutionalized (in the view of neo-institutionalist school).

Business operation of public and private organizations is reflected in the financial statements that should be made in compliance with the identified type of financial reporting; they should provide a true image regarding the financial position of an

organization, its financial performance, cash flow. The information provided in these financial statements are very useful for final users, whether they are shareholders, managers, the government or social actors or the general public.

Depending on the truthfulness and completeness of presented information, best managerial, political and economic decisions may be taken. Moreover, from the perspective of other business operators that enter into business relations, these information should be known as they contribute to the pervasive dissemination of business trust and consequently to the decrease of transaction costs. The decrease of transaction costs will encourage the entrepreneurship to intensify business relations inducing an engagement effect in the national economy as a whole.

Table 2. Final users – taxonomy and motivation

	Taxonomy	Reason
Users of financial statements	Investors	Inherent risk of transactions and the profit brought by investments
	Employers	Organization stability and efficiency
	Financial creditors	Company liquidity and solvency to pay back interest and loans
	Business suppliers and creditor	Continuation of partner company business operations
	Clients	Continuation of supply company operations
	The Government and its institutions	Setting the policy to be implemented

Source: Adapted after Căruntu, 2011.:91.

The financial statements are made based on a set of standards developed by I.F.A.C. that aim to structure data in financial statements, to ensure their transparency, comparability and consistency, irrespective of the nationality of the entrepreneur.

To establish whether the standards have been used and the presented information may be reasonably trusted, it is necessary to perform an internal audit that is in fact the interface between those who present information and final users.

Financial audit reduces the risk of presenting false information (due to an error or intentionally), provides a specialized view on presented information (and its compliance with the reality), it may identify some cases of fraud (even if this is not necessarily its purpose) and through the opinion presented by experts, a convergence may be made between the business interests of the audited organization and final users.

CONCLUSIONS

Formal and informal institutions evolve according to a specific paradigm rooted in the context and values of a society found on a specific level of historic development. That is why they may be improved even though they have at their basis specific subjective views. Informal institutions may replace formal institutions until the latter find their social legitimacy.

Irrespective of their type, the institutions will direct the behavior of entrepreneurs by their power to provide incentives, infrastructure needed to reduce transaction costs, disseminate business trust; encourage research and development sand through their power to penalize inadequate behavior. They do not manage to do this all the time due to their imperfection. Consequently, there is a risk of economic growth slowdown in close relation with entrepreneurial tendency towards destructive operations.

Some national or supranational organizations have to find solutions for lack and inefficiency of institutions becoming institutional entrepreneurs. Institutional

entrepreneurship is not easy if we take into account that it tries to change or introduce new institutions and mechanisms to the detriment of the old ones still supported by social inertia.

Thus, the legitimacy of this type of entrepreneurs is questioned; the solution is being seen in the use of experts having notoriety and in the involvement of professional organizations that become institutional entrepreneurs.

If this tendency is triggered, a set of rules, norms and standards develops first without decision-makers that acquires legitimacy in time and used extensively becomes a standard routine. This is the case of I.F.A.C. standards that have the role of creating the premises for the appearance and dissemination of business trust.

To ensure that the set of standards is used, the financial audit becomes a sine qua non condition changing, in our view, this type of activity into a manifestation of institutional entrepreneurship.

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