

Firm Corruption, Accounting Failure and Anti-social
Entrepreneurship: an institutional perspective

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Abstract

This paper views firm corruption as a failure of accounting systems because of anti-social entrepreneurship. It is argued that to understand this failure an institutional analysis is necessary. Corruption is defined as a skewing of organisational objectives to the advantage of particular actors, with 'fundamental corruption' involving the possibility that removal of corrupt practices undermines organisational viability. A two-stage analytical framework is adopted because accounting systems have a dual function: they institutionalise organisational activity and they act to further instrumental gain of particular actors. The first stage of the analytical framework is based on a Kantian logic in which choices are made because they are universalisable. These first stage choices provide parameters to second stage instrumentally based decisions in which individual gain is the motivating principle. If all actors have the same first stage choices corruption will not emerge in the second stage of the analysis either because all agents decide not to be corrupt or all agents know that corruption is possible and so will adjust behaviour accordingly. Hence a necessary condition for corruption to emerge is that there is not a single view of reasonable and appropriate behaviour. This first stage complexity allows second stage anti-social entrepreneurship i.e. exploitation for personal gain. In the second half of the paper this general framework is applied to accounting systems and the failure of such systems. Four different views on accounting are identified that have different views on authority and information use. Although one particular perspective is identified as being closest to the suggested two stage analysis, this can be complemented by insights provided by other views of accounting failure.

Introduction

The primary objective of this paper is to theorise and present an analysis of firm corruption. Given this objective the discussion is necessarily abstract and conceptual. But this should not blind us to the obvious practical motivation behind the discussion: the emergence of significant corrupt activity at the end of the 20th century involving, for example, the famous cases of Enron, Parmalat and the like.¹ Traditionally in economics the analysis of corruption is oriented to a study of the government sector, state bureaucracies and public sector procurement policies.² Several other studies relate corruption to growth, poverty or governance aspects, especially for the case of developing countries.³ In this paper a different approach is adopted that concentrates on corrupt practices within the private firm sector. In particular corruption is viewed as a failure of accounting systems because of anti-social entrepreneurship. It is argued that to understand this failure an institutional analysis is necessary.

The rest of the subject matter is organised as follows. In the first half of the discussion a rather extended definition of corruption is presented. A preliminary economic definition involves a skewing of organisational objectives to the advantage of particular organisational actors. In addition what is called ‘fundamental corruption’ involves the possibility that removal of corrupt practices undermines organisational viability. The failure of accounting systems that this fundamental corruption implies is analysed using a two-stage framework because accounting systems have a dual function. On the one hand these systems institutionalise organisational activity, on the other hand they act to further instrumental gain of particular actors. The first stage of

¹ See Dietrich and Sharma (2004) for detailed case studies of corruption at Enron, Parmalat and Shell.

² See Rose-Ackerman (1975) for a seminal analysis of this type of analysis that is centred on corruption in the government sector.

³ See, for instance, Bhagwati (1982) and Krueger (1974).

the analytical framework is based on a Kantian logic in which choices are made because they are universalisable i.e. they are reasonable and appropriate in particular circumstances. These first stage choices then provide parameters to second stage instrumentally based decisions in which individual gain is the primary motivation. If all actors have the same first stage universalisable choices then corruption will not emerge in the second stage of the analysis. This is the case either because all agents decide not to be corrupt or all agents know that corruption is possible and so will adjust behaviour accordingly. Hence a necessary condition for corruption to emerge is that there are at least two sets of first stage choices i.e. there is not a single reasonable and appropriate decision. This first stage complexity allows second stage anti-social entrepreneurship i.e. exploitation for personal gain.

In the second half of the discussion this general framework is applied to accounting systems and the failure of such systems. Four different perspectives on accounting are identified based on different views of organisational authority and information use. These four views provide different, and complementary, perspectives on accounting failure. In general terms it is argued that accounting must be viewed in its institutional context to have an adequate analysis of accounting failure and corruption consistent with the two stage general framework developed here.

Defining firm corruption

This section considers the important, if lengthy and far from straightforward, preliminary issue of defining firm corruption. To indicate the complexities involved a

useful starting point is to present a standard (dictionary) definition.⁴ An initial point is that there are both active and static perspectives. Corruption is (a) the act or process of corrupting and (b) the state of being corrupt. It will be argued below that this dual perspective is important not only for the semantics involved but also to understand the economics of corruption. In addition to these active and static views, corruption involves one or more of the following characteristics:

1. Lack of integrity or honesty (especially susceptibility to bribery); use of a position of trust for dishonest gain.
2. Inducement by improper means to violate duty (as by committing a felony).
3. Moral perversion; impairment of virtue and moral principles.
4. Destroying someone's (or some group's) honesty or loyalty.
5. Undermining moral integrity.

Before developing (1)-(5) in the context of firm corruption we can make the following preliminary observations. Characteristics (1) and (2) have an obvious economic relevance in that they are based on instrumental benefit i.e. 'dishonest gain' and 'inducement by improper means'. But equally it is clear that the corrupt characteristic of this benefit is institutionally specific i.e. what is corrupt in one institutional context may be socially acceptable gain or inducement in a different context. In addition if we view economics in terms of analysis based on instrumental gain alone, with, for example, consumers maximising utility and firms maximising profit, it follows that characteristics (3)-(5) are irrelevant to an economic analysis of corruption. But it will be argued below that if we wish to analyse changes in the nature of firm corruption,

⁴ The definition presented in the text is based on that provided by the on-line Dictionary.com, the URL of which is <http://dictionary.reference.com>.

involving for example why corruption became more evident towards the end of the 20th century, then (3)-(5) are important for an economic analysis.

Given these comments we can offer a preliminary definition of firm corruption.

Following Dietrich and Sharma (2004) we can distinguish between (a) non-corrupt firms; (b) non-corrupt firms with corrupt individuals; and (c) corrupt firms. In terms of accounting systems, type (a) firms are those with effective management and financial accounting arrangements. Effective management accounting ensures non-corrupt internal functioning. Effective financial accounting ensures non-corrupt organisational objectives. But we can note that non-corrupt objectives can only be gauged against the power and authority of stakeholders. To some extent the power and authority of stakeholders is firm specific, and in this context is defined by, for example, legal and ownership characteristics. But in addition, this power and authority is socially constructed by general institutional characteristics. Type (b) firms imply a failure of management accounting systems but effective financial accounting arrangements. An example here is Barings Bank in which a Far East trader was allowed to extract significant personal financial advantage from unrecorded trades that eventually precipitated the collapse of the company. In Barings the key problem was that organisational coherence was limited because control systems were clearly undermined by individual aspirations i.e. there was not an effective mapping from firm objectives into coherent operations.

Examples of type (c) corrupt companies are the famous cases of Enron, Parmalat and Royal Dutch Shell. The general characteristic here is that while organisational coherence is high, i.e. the company has an effective management accounting system,

there is a skewing of organisational objectives to the benefit of particular stakeholders, i.e. there is a financial accounting failure. Corruption results when this skewing takes on anti-social significance. It might be argued that this definition of firm corruption is rather extreme, in which case it is appropriate to identify two sub-types. First are those companies in which corruption is endemic or core to organisational activity and secondly are those companies in which corruption is non-core to organisational activity. These sub-types can be called fundamentally corrupt and anti-social firms respectively. In terms of the earlier general definition of corruption, fundamentally corrupt firms are corrupt in active and static senses, whereas anti-social firms are corrupt in only an active sense. This active/static distinction is further explored below. With fundamentally corrupt companies, removal of the corrupt activity, by reorienting objectives to reflect stakeholder interests in general, implies that an organisation becomes effectively non-viable. This would seem to be the case with companies such as Enron and Parmalat. With anti-social firms, reorientation of the objectives results in reduced profitability but organisational viability is not fundamentally undermined. This would be the case with successful anti-monopoly or cartel activity. Perhaps more topically we can also cite the case of Shell that overestimated oil stocks because of the financial advantages that were derived. This paper is primarily interested in fundamentally corrupt corporations.

In practice it would appear that a skewing of objectives requires a formal or informal alliance between a firm's senior management and other powerful stakeholders, and in particular financial institutions and auditors. Two comments would seem to be pertinent in this regard. First, such alliances take on greater significance when financial and auditing services are provided by companies that have skewed

objectives themselves. This skewing can be viewed as undermining wider professional responsibilities. That this has been indeed the case is indicated in the earlier cited cases of Enron and Parmat (see Dietrich and Sharma, 2004). The second comment is that in Anglo-Saxon type economies auditing is a core way in which ex-post information provision is institutionalised. It follows that corruption of the auditing process is a necessary basis for wider corporate corruption; hence the significance of accounting companies having skewed objectives. In Japanese and many European based economies the auditing function is complemented by a greater direct but private managerial, rather than arms-length, role for the banking system. In principle this direct information provision might undermine corruption that follows from a sole reliance on arms-length ex-post information provision. But equally it might increase the possibility of corrupt practices emerging, if the objectives of the banking system are skewed, because of the tighter and longer term alliances between companies and financial institutions. This highlights the importance of objectives being guided by appropriate professional responsibilities, a point taken up in later discussion.

If we accept the definitions of corruption offered here then in general it is based on a failure of accounting systems (Stiglitz, 2003). This failure allows a skewing of firm objectives and hence instrumental gain for some stakeholders at the expense of others. But if we limit ourselves to this definition, standard economic methodologies remove corruption from the analytical stage. This removal might suggest that the definition itself is inadequate. Consider the explanations provided by principal-agent theory with incomplete contracts (e.g. Hart, 1995a) and transaction cost economics (e.g. Williamson, 1975, 1985). In the first case corruption is controlled by appropriate

governance rules that define ownership in an optimal manner. In the second case corruption produces transaction costs that are controlled by the development of similarly efficient institutional arrangements. These interpretations are illustrated by the following views. Hart (1995b, p686) claims that⁵

There is in fact a strong argument that a market economy can achieve efficient corporate governance without government intervention... The company's founders have an incentive to choose an efficient corporate governance structure, that is one that maximises the aggregate return to all claimholders, at the time the company goes public... The reason is that as long as the founders sell the claims in a competitive market they will receive an amount equal to the (net) present value of the returns on all claims. They therefore have an incentive to choose corporate governance rules that maximise total surplus.

Williamson (1999, p1105) argues that

Dysfunctional consequences and other long-run propensities will not be mindlessly repeated or ignored.

In both cases, if corruption exists it is a short-run, disequilibrium phenomenon. From Hart's perspectives until optimal ownership rights are imposed, and from Williamson's view until institutional arrangements evolve to control the corruption as effectively as possible. In either case, corruption has long-run viability only if government activity blocks private sector activity. In which case, we return to perspectives that view government as the core of the corruption problem, as cited earlier. It follows that an analysis of uniquely firm corruption is somewhat limited. In the current context there is a central problem with these contract based frameworks. It is necessary that ownership (in Hart's incomplete contracts framework) and the nature of transactions (in Williamson's transaction cost framework) are unambiguously defined. To put this issue rather crudely, when ownership rights are allocated or when

⁵ Hart cites two possible problems with the 'Chicago' view cited in the text: externalities and unforeseen contingencies. According to Hart "The externality argument ... is not all persuasive" (p.687); and "the case for the government to impose statutory rules on companies on the grounds that 'the world has changed' is not strong" (p688).

a transaction is undertaken, this means the same thing to all parties involved. If this is not the case the analysis of firm corruption is somewhat more complex.

Consider, first, the issue of ownership. We can follow Kay (1997) who points out that, according to legal principles, ownership is defined in terms of eleven characteristics: a right of possession; a right of use; a right to manage; a right to income from ownership; a right to the capital value; a right to security from expropriation; a power of sale or disposal; no time limit on ownership rights; a right of residual control; property can be used to obtain satisfaction of legal judgement against the owner; a duty to refrain from harmful use. Two important implications follow from this legal definition. First, it is clear that individual shareholders do not own companies instead they own shares. So, for example, shareholders have a right to use, manage, derive income from and dispose of shares. But no individual shareholder has the right to use, manage, derive income from and dispose of the assets of a company. The second implication is that we cannot even argue that companies are collectively owned by shareholders. This follows because shareholders, collectively or individually, have no duty to refrain from harmful use of company assets, i.e. the final ownership characteristic just highlighted. In our context harmful use covers corrupt practices. Managers have a duty to refrain from harmful use of a company's assets, but equally this does not imply that managers own companies. In short, we can follow Kay (1997) and suggest that the ownership of publicly quoted companies is inevitably ambiguous. With unambiguous ownership, corrupt practices can be viewed as the result of managerial strategic intent combined with inefficiently managed ownership rights. With ambiguous ownership the analysis is less straightforward.

In narrow economic terms, with unambiguous ownership it is possible to define the principal(s) and agents in any relationship. With ambiguous ownership the definition of principal(s) and agents is not a priori clear. This lack of clarity implies that the actual functioning of principal-agent relationships is ex-post institutionalised in actual economic processes rather than being an ex-ante determinant or guide to the structure of these processes.⁶ In short, with ambiguous ownership institutional arrangements are required before ownership rights are determined in practice. The resulting complexities involved here are developed below.

Although this argument is constructed in terms of ownership, the same issue arises for transaction cost theory. In this case the nature of transactions must be unambiguous. In abstract terms we can depict transaction cost reasoning in the following way (see Dietrich, 1994). Technologically defined economic units are assumed to exist. These units undertake economic exchange. Institutions emerge to minimise the costs of this exchange. In legal practice, rather than in economic interpretations of legal theory, economic exchange involves a duty not to do harm. So, if different parties to a transaction have different definitions of refraining from harmful use then the nature of the transaction will be different to different parties. It follows that corrupt purchase and sale can result to the advantage of one of the parties. This follows from a 'natural' economic assumption of opportunism that is characteristic of transaction cost reasoning (see Williamson, 1985). This problem becomes most apparent with trading

⁶ As discussed in Dietrich and Sharma (2004), this complexity is recognised in formal economic theory by Douglas and Whinston (1986) when they suggest that 'common agency' may be significant. Examples of common agency fall into one of two categories: delegated or intrinsic. Delegated common agency arises when several parties voluntarily bestow the right to make certain decisions upon a single (common) agent. Intrinsic common agency arises when an individual is "naturally" endowed with the right to make a particular decision affecting other parties, who may in turn attempt to influence that decision. Both possibilities involve a number of principals who simultaneously announce incentive schemes for a common agent. In the presence of collusion institutional remedies for the resulting inefficiency are needed. In addition the distribution of net rewards among the principals is, in general, indeterminate when we have common agency.

relations between parties from different cultural backgrounds. In this case, bribery in one context may be standard commercial practice in another (Dietrich, 2005). In abstract terms we see the same complexity as that just considered with ownership. If the nature of a transaction is different to different parties, this implies that transactions are institutionalised in different contexts. The implication is that transactions are not exogenous features of an analysis that are used to derive institutional structures. Instead there is a prior institutionalisation of transaction characteristics that need not be the same for all parties.

To avoid the complexity of prior institutionalisation considered here we must have universally accepted norms of behaviour that define appropriate, harmful and corrupt economic practices. Given these universally accepted norms, corruption can be viewed in a standard economic manner as being a rational decision to maximise financial return given exogenous conditions. The exogenous conditions include: technological features and commercial cost and revenue potential; the nature of the legal system that defines the probability of detection and punishment costs; and individual attitude to risk, with corruption only being undertaken by risk loving individuals. Because of these characteristics, and in particular because of the required attitude to risk, we can depict this 'rational corruption' as 'equilibrium anti-social entrepreneurship'. To reiterate an earlier point: the standard conclusion is that corruption requires non-competitive returns, because of government protection, and a skewed probability of detection, once again because of government protection. In short, equilibrium anti-social entrepreneurship requires government protection. Without this protection private agents will manage corrupt practices.

But corruption appears to be most evident historically when views of harm, and general institutional arrangements, are subject to radical change, as was the case with 18th - 19th century development of market capitalism (see Polanyi, 1944) and the late 20th century resurgence of market capitalism. There appear to be two possible responses to this linking of corruption and radical socio-institutional change. First, it might be viewed as a short-run disequilibrium that can be ignored in a comparative static analysis, as seems to be the case with transaction cost economics and principal-agent incomplete contract theory just considered. Secondly, and more usefully for the current discussion, the disequilibrium institutional conditions can provide anti-social entrepreneurial opportunities. These opportunities are not the equilibrium anti-social entrepreneurship just discussed, but instead can be analysed using an Austrian inspired logic (for example, Hayek, 1945; Kirzner, 1972). Here, disequilibrium conditions, along with individually specific tacit knowledge, create commercial opportunities from ‘pure’ entrepreneurial behaviour (to use Kirzner’s term). In a standard interpretation, this entrepreneurial behaviour reveals the underlying knowledge that is being exploited and so equilibrates a market. In equilibrium all economic agents would therefore have full knowledge and so no opportunities would exist for ‘pure’ Austrian entrepreneurship. The same logic can be applied to institutional disequilibrium, when views of harm are being changed. The resulting ‘Austrian anti-social entrepreneurship’ will diffuse new ideas of harm throughout an economy. Hence when these ideas are fully accepted we enter the Hart-Williamson world of institutional equilibrium.

While this logic is inspired by Austrian theory, we should recognise a key departure. Austrian theory uses an individualist logic in which ownership rights are given an a

priori status (Dietrich, 2005). There is no room in this approach for viewing such rights as being contingent on a requirement not to do harm, as is the case with actual legal ownership. The obvious complexity here is that ideas of harm are socially constructed. To this extent ownership is similarly socially constructed; it cannot exist without an institutional-social context. The implication here is a departure from a traditional Austrian theory of ownership in which any view of legal institutions is that they are derived from individual rights (Menger, 1978; Hayek, 1973). With issues of corruption, a socially accepted view of harm must exist and be institutionalised to allow the definition of ownership rights.

This necessary prior institutionalisation introduces an important policy implication. Prior institutionalisation implies that institutional structures are path dependent, for reasons set out by (North, 1990). But note that, whereas in North's framework institutional path dependencies generate long-standing economic growth differentials because of a lack of institutional convergence, here the same path dependencies generate long-standing corruption differences. It, therefore, follows that Austrian anti-social entrepreneurship need not generate an institutional equilibrium that is free from corruption, and in which a Hart-Williamson logic is adequate for analysis. In addition, as there is unlikely to be an institutional equilibrium generated by private sector agents, there is an obvious role for government anti-corruption policies aimed at reconstructing institutional structures.

Corruption as a two stage process

To accommodate the complexity that ownership requires a prior conception of harm, and therefore a prior existence of institutions, an analysis of corruption is presented

here that mirrors an economic analysis of ethical decision making. The potential relevance of framing an analysis of corruption in a similar way to an analysis of ethics is indicated by the general definition of corruption presented at the start of this section. In the earlier definition corruption was shown to have five characteristics. The first two were based on a link between corruption and instrumental gain. The last three involved ‘moral perversion; impairment of virtue and moral principles’, ‘destroying someone's (or some group's) honesty or loyalty’ and ‘undermining moral integrity’. In short corrupt behaviour has important characteristics that are the obverse of ethical behaviour and involve the undermining of ethical practices.

Dietrich and Rowen (2005) argue that an economic analysis of ethical decision making, that reflects complexities developed in other disciplines, particularly philosophy, must use a two-stage decision process. The context of this two-stage decision process is provided by Sen (1977, 1987) and Etzioni (1986, 1988). The former writer argues that ethical behaviour can demonstrate either commitment or sympathy. Sympathy reflects the notion that an individual’s welfare is directly affected by a concern for other individuals, whereas commitment reflects the idea that although an individual’s welfare is not affected by a given situation, the individual is prepared to take action about the situation as they do not believe that the situation is ethically acceptable. Etzioni uses a similar distinction. He argues that an individual derives qualitatively different benefits from actions motivated by self-interest and from actions motivated by other-regarding considerations. Satisfaction is obtained by satisfying self-interested preferences and hence is obtained by doing actions that generate instrumental benefit, whereas affirmation is obtained by satisfying ethical or other-regarding preferences and hence need not be likable, enjoyable or pleasurable.

According to Etzioni, an ethical act, which achieves affirmation, may not necessarily be the act that gives the individual the most satisfaction.

The distinction between commitment/affirmation and sympathy/satisfaction lead Dietrich and Rowen (2005) to suggest that any ethical decision is based on a two-stage process. The first stage of the process involves a decision to behave ethically because this is deemed correct, not because of any instrumental advantage obtained. This captures notions of commitment and affirmation. Only given a first stage commitment to ethical behaviour is instrumental gain obtainable in which sympathy and satisfaction are relevant. An important conceptual issue that is solved using this two-stage analysis is that only in the first stage can people make a real choice to behave ethically (or otherwise). In the second stage, in which ethical behaviour emerges because of instrumental gain, no real choice is possible as there is no logical possibility of not choosing the optimal solution. This lack of real choice with instrumental decision making is, of course, a standard criticism of an orthodox economic analysis of decision making (Lawson, 1997).

In game theoretic terms, second stage decisions can be analysed using standard Nash criteria in which decisions are made because it is in the interests of individuals to make such decisions. But first stage decisions can be analysed using a Kantian logic in which actions are chosen because they are universalisable. The Kantian model of rationality suggests that individuals are motivated by reason and hence will choose actions that are universalisable, contrary to the usual assumption of choosing actions according to preferences (Hargreaves-Heap, 1992). Actions must be universalisable in the sense that they are not agent specific and are able to be chosen because it is

desirable, reasonable and possible when generally followed. Hence actions are dictated by reason rather than necessarily by preferences. In formal terms, these Kantian decisions endogenise the structure of the second stage of the game that can therefore take different forms depending on first stage decisions.

In terms of corruption, this two stage perspective allows us to accommodate the earlier definition in which corruption is both a state and an act. It is only possible to conceive of a state of corruption if this is universalisable; this state of corruption therefore corresponds to the first stage of the decision process. Actual corrupt activity is only undertaken in the second stage when tangible benefit is obtained. To reiterate an earlier point, first stage choices are real because the option of a non-corrupt choice is available and possible. All that is required is that the choice of a corrupt strategy must be universalisable in the sense that it is a reasonable and possible decision. We can note two complexities about this first stage decision. First, what is reasonable and possible in any particular situation, i.e. what is universalisable, is dependent on prevailing institutional configurations. This echoes the earlier point about prior institutionalisation. It follows that there is no natural and universal definition of specific corrupt practices. For instance bribery might be considered corrupt but in other circumstances need not be. Secondly, for corruption to be possible, these prevailing institutional configurations must be non-homogenous, i.e. universalisable choices that are deemed appropriate and routine must be different for different people. This requirement of more than one universalisable choice follows from the fact that second stage corrupt gains are based, in a fundamental sense, on exploitation.⁷ If one

⁷ Dietrich and Rowen (2005) show that non-ethical first stage choices imply a second stage decision that is either structured as a chicken or prisoner's dilemma game. In terms of the discussion in the text, the first possibility results when exploitation gains are small whereas a prisoner's dilemma game results when exploitation gains are large.

set of individuals can extract corrupt gains then another set of individuals must incur losses because of the corruption. This reallocation of resources is only possible given different expectations of appropriate and possible (i.e. universalisable) behaviour. If prior institutional arrangements are sufficiently powerful and constraining that there is no real divergence of first stage choices then corruption is not possible, at least in theory. Two particular variants of this non-existence of corruption can be highlighted. First, if there is no reasonable expectation that corrupt behaviour is reasonable, viable and possible, this will undermine the possibility of second stage corruption actually occurring. This lack of universalisable corruption removes the possibility of anti-social Austrian entrepreneurship. Secondly, if corruption is the only universalisable first stage choice then this also removes entrepreneurial gains. In this case because we enter a Williamson-Hart world in which everyone anticipates exploitation and hence can construct contracting and ownership arrangements that ensure its effective decentralised control. But both possibilities are arguably theoretical rather than actual, hence corruption is likely to be a real issue that requires analysis and policy intervention.

Corruption and accounting failure

The previous sections presented an extended definition of corruption. Part of this discussion considered ways in which corruption can be viewed as anti-social entrepreneurship. This section continues the same theme and extends the analysis of the linkage between corruption (and anti-social entrepreneurship) and the failure of accounting systems. Corruption in the context of firm activity clearly involves such a failure. But the current discussion departs from traditional views of corruption and accounting failure (for example Stiglitz, 2003) by offering a more institutionally

informed view. From an institutional perspective, accounting systems define and constitute two aspects of organisational activity: control structures and control processes (Dietrich, 2001). Accounting as control structure is a key aspect of authority inside and outside the firm (a precise definition of authority will be presented shortly). Accounting as a control process involves information use. It follows that if we are to understand the linkages between firm corruption and accounting failure we must explore the ways in which corruption undermines structure and process and in turn authority and information use. An important complexity here is that from both accounting and institutional perspectives there is no single view on these matters.

With respect to accounting as a control structure we can follow Tirole (1988) and distinguish between supervision and authority. Supervision can control activity when information and contracts are complete. Hence it assesses the extent to which individuals pursue goals that are agreed ex-ante. It follows that supervision involves equal contracting parties. Any authority only exists with incomplete contracts. In such circumstances adaptation to contingencies is carried out ex-post. The ability to control and guide this adaptation defines authority. The key point is that rules used to adapt to contingencies are not simply a matter of ex-ante agreement between equal parties but that ex-post there is an unequal distribution of the potential to control adaptation. The ultimate motivations of the parties are irrelevant here, we can think of dictatorial or benevolent authority figures.

Using the framework set out in the previous section, we can suggest that when there is a single view of appropriate and relevant (i.e. universalisable) authority, corruption will not occur. In such circumstances the actual setting of rules, rather than formal

contractual obligation, is accepted by all parties, and hence the control structure is characterised by a high degree of internal coherence. But corruption can undermine authority, and hence lead to accounting failure, when no single universalisable view of authority exists. Different views on the ways in which accounting institutionalises authority clearly can exist. These different views suggest different perspectives on the internal coherence of accounting systems. This implies different views on the significance of how corruption can undermine accounting systems.

To simplify matters we can suggest that different perspectives on the firm view authority as either being necessary for coordination purposes or as a constraint on economic activity (specific references will be given below). With respect to the coordination view, it might be argued that authority and the coordination this provides has efficiency advantages. In terms of the framework suggested here, such efficiency advantages are readily universalisable hence there is no potential for corruption. With respect to the constraint view of authority, relationships and more specifically accounting systems are viewed as promoting the interests of particular economic agents. This involves self seeking behaviour that is aimed at the control of economic rents. If these constraints are not completely universalisable, and hence if there is no general agreement on the sources and distribution of the rents, then corruption can exist.

The relevance of this coordination-constraint distinction is further explored below. Before this we can consider the general issues involved in the link between information use and control processes. Following Ryle (1949) and Loasby (1998, 1999) we can draw a distinction between ‘knowing that’ and ‘knowing how’.

‘Knowing that’ involves knowledge of facts and relationships and is the primary result of formal education and the news. ‘Knowing how’ concerns the ability to perform appropriate actions to achieve desired results. This includes knowledge of a particular skill and knowledge of when and where this skill should be used. According to Loasby traditional economic views on the linkage between information use and control are based on ‘knowledge that’ specific quantities of output may be produced given technical parameters. In this perspective there is no knowledge of how this is to be achieved.

To orient thinking we can view ‘knowledge that’ as passive and arm’s length use of information and ‘knowledge how’ as active use of information aimed at specific tasks (Dietrich, 2001). An important issue with ‘knowledge how’, and in particular the skills involved, is that it involves learning that is time and space specific (Hayek, 1945). In terms of earlier analysis, this specificity of ‘knowledge how’ is the basis of a non-homogenous universalisability of decision making and hence is a necessary condition for a corruption of accounting practices. It is no accident that, from an Austrian perspective, the exploitation of ‘knowledge how’ or tacit knowledge is the basis of entrepreneurship. To reiterate an earlier point, all that is required for corruption is that this entrepreneurship takes on anti-social significance. These comments suggest that when there is active use of information there will be disequilibrium in first stage decisions based on universalisability. With a passive use of information, first stage decisions will be stable. The implications for corruption were developed above.

We can now bring together the elements of this discussion and turn to a specific analysis of accounting systems and their failure. Using the distinctions between authority as constraint or coordination and information that is acquired in a passive or active manner, there would appear to be four general control types depending on the structure and processes involved:

constraining authority – passive information acquisition;

coordinating authority – passive information acquisition;

constraining authority – active information acquisition;

coordinating authority – active information acquisition.

Each of these control types defines a particular view on how accounting systems function and hence have a different view on the significance of accounting failure and corruption. To orient thinking we can use the following 2x2 representation of the possibilities involved. Each combination is described in terms of indicative comments that are developed in later discussion.

	<u>Passive information acquisition</u>	<u>Active information acquisition</u>
<u>Constraining authority</u>	1. Firm as passive optimiser 2. Traditional accounting 3. Corruption as legal issue	1. Firm as active regulator. 2. Accounting as symbolic and instrumental significance. 3. Corruption as system issue
<u>Coordinating authority</u>	1. Firm as passive coordinator 2. New institutional accounting 3. Corruption as a contracting cost	1. Firm as active coordinator 2. Accounting as routines, visibility tool, and common language. 3. Corruption as routine/competence

Constraining authority – passive information acquisition

This first combination of structure and process defines a black-box view of the firm with complete contracting. The firm is assumed to optimise over an appropriate

objective function with exogenous and fully specified production function and market constraints. If information issues are recognised they are analysed in terms of standard principal-agent theory which is used to define optimal contracts. It is relevant to point out that the specification of these optimal contracts requires full information of transformation processes and utility functions (Broadbent et al, 1996). It follows that information acquisition is necessarily passive because of the 'knowledge that' logic used. In addition the authority of the principal is used to further (usually) profit maximising objectives, hence it can be viewed as constraining authority. No coordination advantages are derived from authority because of the assumed information characteristics.

In terms of accounting systems we have to imagine a rather artificial world in which monitoring information is provided but at zero cost. This can be characterised as a non-accounting world even though textbook accounting is largely underpinned by textbook (black-box) neoclassical economics (Scapens, 1984; Scapens and Arnold, 1986). As accounting systems have no organisational basis in this neoclassical economic world it follows that corruption of accounting similarly has no organisational basis. Using terms defined in the previous section, corruption can be viewed as rational, equilibrium anti-social entrepreneurship that is a risk loving response to the probability of detection given the potential gains involved. This lack of an organisational basis to the corruption of accounting implies that it is essentially a legal issue.

Coordinating authority – passive information acquisition

While real accounting, and hence real accounting failure, cannot be present in a world defined by constraining authority and passive information acquisition, it is logically possible in a world characterised by coordinating authority and passive information acquisition. In terms of accounting writing the dominant school of thought here appears to be transaction cost theory. As Burns (1998) points out, Williamson's 'markets and hierarchies' framework has probably exerted more influence on accounting research than any other branch of new institutional economics. As discussed earlier (see also Dietrich, 1994), a key point about this account of institutional development is that contracting and technological factors are assumed to be separable. The technologically defined activities are assumed to exist, the organisation of which is determined by contracting costs. Institutions, or 'governance structures' using Williamson's (1985) terminology, can therefore be depicted as passive coordination devices as they are viewed as emerging in response to exogenous contracting characteristics and efficiency seeking behaviour of economic agents. There is no possibility of what might be called 'active coordination', in which contracting behaviour feeds-back to determine the pre-contracting units. In the current context the pre-contracting units define transactions, the nature of which are observable and accepted by all relevant parties. This allows issues of corruption to be viewed as a contracting cost and hence a behavioural determinant of institutional form.

The nature of contract-based accounting system can now be set out. The general existence of accounting is consistent with a contracting-based logic. The development and use of accounting systems involve the very resource expenditures that transaction

cost theory emphasises. These accounting systems provide an important means of codifying rights and responsibilities. Without this codification negotiation, policing and economising behaviour would be difficult if not impossible. In turn changes in accounting systems can be explained as responses to changes in the underlying factors that determine transaction costs, for instance bounded rationality, asset specificity and opportunism. Note here the possibility of an analysis of accounting failure and corruption that might be based on changes in opportunism, buttressed by asset specificity and bounded rationality considerations. Although there is no obvious internal explanation of what might cause such changes.

In this general tradition the historical development of management accounting as been analysed (Johnson, 1983; Johnson and Kaplan, 1987), along with internal organisation (Spicer and Ballew, 1983), transfer pricing (Spicer, 1988; Colbert and Spicer, 1995), and financial control (Ezzamel, 1992). While this approach can provide clear insights, the analysis of accounting failure is constrained by the implicit assumptions upon which new institutionalism is based. In the current context these assumptions can be viewed as coordinating authority and passive information acquisition. In terms of authority, as considered above the key requirement is that all agents accept the characteristics of the system and the way in which it functions. To this extent Williamson (and also Hart) would seem to be making an important insight: acceptance of a contract implies acceptance of the authority embodied in an accounting system. The obverse is also (logically) the case: non-acceptance of the authority structure embodied in an accounting system implies non-acceptance of a contract. Accounting failure, and more specifically corruption, is therefore reduced to an individual issue involving non-acceptance of a contract.

The information basis of new institutional accounting is somewhat more problematic. As considered above, the fundamental characteristics of a transaction must be common knowledge to all parties involved. This necessary common knowledge can only exist in a 'knowledge that' world, hence the requirement of passive information acquisition. Arguably any accounting system, and in particular any management accounting system, involves set-up costs and learning by doing, i.e. the system itself will have firm specific characteristics. Among other things, these firm specific characteristics can provide the basis of Austrian entrepreneurship, and in our context anti-social entrepreneurship. But, this presents a problem for new institutional reasoning because only the individual technologically defined (pre-contracting) units can have specificities from which institutional arrangements are derived. If institutional arrangements, in our context accounting systems, have specific characteristics we cannot derive institutional arrangements from the characteristics of these institutions. Such reasoning is circular.

In general terms this problem can be resolved by adopting a two-stage decision process, as considered earlier. In the first stage pre-existing institutional structures are inputs into universalisable choices. These choices then define the common knowledge (or lack of common knowledge) in second stage decisions. In more concrete terms three ways seem to be used to avoid this circular reasoning. First, we can assume that governance structures (accounting systems) do not have firm specific characteristics. This implies that all information acquisition is passive and corruption and accounting failure are viewed as individual contracting issues. As suggested earlier, this approach implies common knowledge based on a single set of universalisable decisions that

basically removes first stage choices. Secondly, the contracting basis of accounting systems can be removed. This is the coordinating authority-active information acquisition view of institutions to be discussed shortly. While this view allows firm specific institutions it tends to ignore contracting issues. In abstract terms this ‘solution’ concentrates on first stage, rather than second stage, decisions. Finally, the circular reasoning can be removed by using a constraining authority-active information acquisition framework (also considered below). In principle this is consistent with the two stage analysis presented above.

Coordinating authority – active information acquisition

The economic world in which organisational authority is seen as coordinating and decision-making based on ‘knowledge how’ (i.e. active information acquisition) rather than ‘knowledge that’ has come to be called the competence or resource based view of the firm.⁸ For some writers this perspective is viewed as a necessary complement to the more dominant contracting theory (Foss, 1993; Dietrich, 1994; Langlois and Robertson, 1995; Foss and Loasby, 1998). A useful distinction is to view contracting theory as a prisoner’s dilemma game in which the central focus is on motivation and control given the divergent incentives of the actors, whereas competence theory is viewed as a coordination game. The latter structure implies multiple equilibria, but the particular equilibrium or productive opportunity (to use Penrose’s (1980) term) that emerges depends on the firm specific coordination of divergent agent capabilities. In terms of the framework developed in the previous section we can view competence approaches to the firm as being based on the development of firm specific universalisable routines (to use Nelson and Winter’s

⁸ Within economics the foundations of the competence theory of the firm can be found in the writing of Penrose (1980), Richardson (1972) and Nelson and Winter (1982).

(1982) terminology), i.e. they can be viewed as a first stage decision. An implication, therefore, is that second stage (self-seeking) behaviour is largely ignored. A competence approach to corruption would therefore view it as an aspect of firm specific productive opportunity. But this possibility of anti-social competences is apparently ignored. Hence the insight suggested above, that corruption must be based on non-homogenous universalisable choices, is also ignored. A possible theoretical development to competence theory might therefore involve analysis of the development of non-homogenous capabilities and in what circumstances these are linked to anti-social firm activity. The difficulty here for competence theory is the apparent absence of self-interested (second stage) behaviour. Corruption requires a basis that is self-interested (as well as universalisable) because of the exploitation involved.

In terms of links between competency theory and accounting three possibilities can be cited. First, Scapens (1994) emphasises the way in which management accounting represents routine behaviour. As such it is critical to organisation memory and so is the equivalent of the genetic code of the firm (Burns, 1997). The importance of a firm's genetic code, in the form of organisational routines is emphasised by Nelson and Winter (1982). Secondly, Hopwood (1987) points out that accounting is a visibility tool. In a technical sense this would appear to be central to competence theory. The framework is grounded in the importance of firm-specific learning by doing and hence tacit knowledge. This learning transforms factor inputs that have an objective, market based opportunity cost, into firm specific assets the opportunity cost of which can diverge from market price. The opportunity cost of these assets to the firm can be described as an implicit rent to the asset involved and hence need not be

directly observable in the same way as a market cost. It follows that accounting has a role as a visibility tool to render observable this otherwise unobservable rent.

The third link between competence theory and accounting is that stressed by Burns and Scapens (1996). Accounting systems can provide a common language among participants. In terms of the framework presented here this 'common language' is significant as it provides the means to be able to universalise first stage choices. Without a common language these first stage choices would be difficult if not impossible. Earlier it was pointed out that competence theory is, implicitly, a coordination game. The potential lack of coordination in such games, because of the multiple equilibria involved, can be resolved in practice by invoking 'focal points' (Schelling, 1960; Sugden, 1995). In this respect a common language acts as a focal point. In terms of accounting failure and corruption, it can therefore be suggested that a necessary condition is a lack of a single common accounting language. This provides the basis for more than one universalisable choice, and hence the possibility of corrupt exploitation.

Using a competence framework and the ways in which accounting functions within this framework, we can reiterate the point made above that institutional path dependencies are likely to exist. In this context these path dependencies result in the inertia of a firm's productive opportunity. The implication here, as discussed above, is that with non-homogenous first stage decisions Austrian anti-social entrepreneurship need not diffuse knowledge of institutional functioning. In accounting terms, any accounting system creates a set of rules, along with informal routinised behaviour based on these rules. Changes in exogenous conditions will produce changes in

accounting practices if these are incremental to current practices, i.e. if the effects are consistent with current routines. Changes in routines need a restructuring of organisational practices that require a coordinated organisational response. This can be viewed as a coordinated change in universalised choices. Given the costs of such coordinated change a rational response can be accounting inertia.

In short accounting failure can result from this inertia. For example, Johnson and Kaplan (1987) claim that management accounting systems became inadequate for new systems of production management because the evolution of accounting has been driven by cost-economising behaviour. More generally, a major exogenous change can therefore be viewed as the source of a non-homogenous universalised set of first stage decisions. Some agents, or stakeholders, work within the logic of an old set of accounting routines, whereas other agents work using the logic of a new set of procedures. This provides a necessary set of conditions for the emergence of corruption. Sufficiency requires a self-seeking input that is not provided by competence theory.

Constraining authority – active information acquisition

The difference between a constraining authority–active information world and that considered in the previous section can be summarised in terms of a distinction between respectively methodological holism and methodological individualism. The game theoretic basis of competence theory reveals its grounding in methodological individualism. In this latter world the preferences of agents are exogenous. Given ‘knowledge how’ and exogenous preferences learning activity requires coordination,

described in terms of routines and direction. Institutions, and more specifically accounting systems, emerge as a result of these coordination efforts.

In a constraining authority-active information world a reverse logic exists. Institutions are given an existence that precedes individual activity. Following Hodgson (1988) we can suggest that this prior existence is necessary because of the fundamental uncertainty of economic activity. Any economic activity requires a degree of predictability that is generated by institutions constraining uncertainty. If this necessary use of institutions is combined with passive, rather than active, information use, the necessary predictability will be generated by exogenous and non-economic rules that operate as constraints. This describes the world, considered above, in which corruption is viewed as fundamentally a legal issue. But with an active use of information, spatially and temporally specific learning is necessary. In the current context this learning is channelled by pre-existing institutions. An implication is that preferences are viewed as endogenous to institutional functioning.

A danger with a perspective in which institutions channel learning is that individual decisions become 'robotised' and hence devoid of real agency. To prevent this robotisation of decisions we can analyse the institutional channelling of decisions in the Kantian manner suggested above. Fundamental choices, in our context about whether to behave corruptly or otherwise, are based on what is universalisable. But what is considered natural and appropriate in any given situation depends on pre-existing institutional arrangements. As considered in a moment, these institutional arrangements are never neutral, but instead internalise the influence of particular economic agents. If we build on the perspective offered in earlier discussion, changes

in conceptions of economic harm, along with other exogenous conditions, fracture what is considered universalisable and hence lead to institutional change. It follows that a constraining authority-active information world is necessarily evolutionary, a conclusion consistent with that suggested by Hodgson (1999).

We can develop the implications of this framework for accounting, and along with this accounting failure and corruption, in two contexts: by viewing accounting as a professionalized activity and by incorporating a symbolic as well as an instrumental significance to accounting. With regard to accounting as a profession, Dietrich (1997) uses the work of for example Armstrong (1985, 1987) and Fligstein (1987) and shows how professionalized accounting control can become locked into a particular organisational context. In addition, as Perkin (1989) stresses, this organisational dominance reflects a wider social dominance. This perspective is consistent with that suggested by Roberts and Scapens (1990) in which accounting is viewed as enhancing the position of particular organisational actors relative to others.

This recognition of accounting as a profession, and the way this reinforces organisational dominance, to some extent provides access into an analysis of corruption. The failure of accounting can be viewed as senior organisational actors, the dominance of whom is based, in an organisational setting, on accounting systems, shifting towards overwhelming monetary rather than non-monetary objectives (Dietrich and Sharma, 2004). But recognising this role for accounting introduces an analytical problem. The dominance of accounting as a profession provides prior institutionalisation that is necessary for organisational functioning. This institutionalisation is not based on instrumental advantage if the preferences of

organisational actors are viewed as endogenous to the institutional-organisational setting. Instead a useful way of analysing this institutionalisation involves a non-instrumental Kantian logic. In short there is an analytical problem in simultaneously linking the professionalisation of accounting to prior institutionalisation and instrumental gain.

To disentangle this problem we can follow Dietrich and Roberts (1997, 1999) and suggest that professionalisation is based on both efficiency and power. Efficiency advantages of professionalisation are based on contracting or tacit knowledge benefits. Professionalisation and power involve rent seeking behaviour. The key point is that the management of knowledge and contracting issues involves inevitable power asymmetries. In turn undermining the power asymmetries involves inevitable efficiency losses. This perspective can be incorporated into the two-stage decision framework suggested above. The efficiency advantages of professionalisation are chosen using a Kantian logic. These natural and appropriate choices structure second stage decisions that involve instrumental gain based on power asymmetries. Using an insight invoked frequently in earlier discussion, accounting failure and corruption is then based on a fragmentation of first stage choices i.e. professionalisation means one thing to one group of people and a different thing to another group. This fragmentation then allows Austrian anti-social entrepreneurship and second stage exploitation.

This two-stage analysis of accounting as a profession, and also accounting failure, can be further developed by recognising that accounting activity can be viewed as having symbolic as well as instrumental significance. Carruthers (1995) suggests that

accounting is a legitimation tool to a firm's outside world. More generally Burns (1998) argues that analyses of accounting based on Veblenian old institutional economics are important in explaining the role, functioning and evolution of accounting. He uses ideas suggested by Tool (1993) and Bush (1987) to stress the ceremonial as well as instrumental significance of accounting activity. This ceremonial significance is used to maintain the status quo by powerful groups. This is illustrated by Hanlon (1997) in his analysis of 'shifting professionalism' in accounting. These perspectives can be incorporated into the two-stage framework used here. The universalisation of accounting legitimises the existing world view, a process that is reinforced by ceremonial activity. In addition 'shifting professionalism' opens the possibility for accounting failure and corruption.

Conclusion

This paper has presented an analysis of firm corruption that is based on a two stage decision making framework. The first stage presents fundamental choices to be corrupt (or otherwise). These choices are analysed in terms of what is appropriate and reasonable in particular circumstances i.e. what is universalisable. A necessary, but not sufficient, condition for firm corruption to emerge is that more than one set of universalisable decisions exist. This allows the development of Austrian entrepreneurship. A sufficient condition for corruption involves first stage complexity plus second stage incentives for corrupt exploitation. This allows the Austrian entrepreneurship to take on anti-social significance.

The second half of the paper applies this general framework to the specific issue of corruption as accounting failure. Four different perspectives on accounting are

identified that have different views on authority and information use. Although one particular perspective is identified as being closest to the two stage analysis used here, this can be complemented by insights provided by other views of accounting failure.

To some extent the framework presented here can be applied more generally to other examples of anti-social activity. For instance organised crime can be analysed in a similar manner involving a two-stage analysis and anti-social entrepreneurship, with the anti-social element being arguably more extreme than with corruption. The difference between firm corruption and organised crime involves organisational details. Corruption has organisational complexities that are similar to non-corrupt firms, and have been analysed accordingly in this paper. Organised crime involves an absence of formal contracts, and therefore a greater role for loyalty and trust along with violence and coercion. A possible issue for future research involves extending the framework developed here to cover anti-social behaviour in general, with corruption being a specific case.

One final matter can be briefly considered in this conclusion. The discussion started by distancing the framework used here from more traditional economic approaches of corruption that are centred on the government sector. In this conclusion it is appropriate to consider, briefly, possible policy implications of the framework. If we adopt a traditional Austrian perspective, the entrepreneurship that underlies corruption will diffuse knowledge of different world views and so eventually equilibrate the institutional structure of an economy. From this perspective government activity can at best speed up this process but at worst block the positive benefits of anti-social behaviour. But this traditional Austrian perspective ignores the significance of

institutional path dependencies. If the importance of the two stage analysis is accepted what are viewed as relevant and appropriate decisions will contain a high degree of inertia. In addition state policy itself will involve its own organisational inertia for similar reasons to the private sector, that is likely to be compounded by close interconnections between senior organisational actors and state activity. In short it is by no means obvious that we can rely on (a) the private sector being self-policing or (b) automatic anti-corruption policy initiatives. But the framework developed here would seem to require an active anti-corruption role for the state.

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