

# Institutional Environment of Internal Controls in Autonomous Establishments



Tatiana B. Turishcheva, Ravil G. Akhmadeev, Lyubov A. Chaykovskaya

**Abstract:** *This paper examines the institutional setting of internal controls, the existing problems in the relations between institutions, and suggests possible ways to resolve such problems. The outcomes of the scientific and practical examinations conducted by the authors have revealed the mutual interaction between the institutional environment of an autonomous establishment and that of the establishment's internal controls, manifesting itself in the direct interaction with the autonomous establishment's internal institutional environment, both at the micro- and meso-levels, subject to proper analytical support.*

**Index Terms:** *autonomous establishment, accounting, institutional environment, economic entities, efficiency, internal control, external control*

## I. INTRODUCTION

Like any other economic entity, an autonomous establishment operates in the context of applicable fundamental political, social and legal regulations or, in other words, under the influence of a clearly defined and well-organized network of institutions that determine the institutional setting for the operation and development of economic entities. Hence, the entire management process and its functions, including the establishment's internal controls, in fact, operate and function under the influence of the institutional environment [1]. The concept of institutionalism includes two aspects, namely "institutes", i.e. cultural norms and customs of behavior, and "institutions", i.e. the establishment of norms and customs by means of laws, organizations, and entities.

It should be noted that in modern studies [29, 8, 2, 28, 31], the concept of "institutionalism" is constrained to institutions, that are defined as consistent ways of thinking inherent to a large community, thus, contributing to the theory of evolutionary selection of institutions, first declared by W.C. Mitchell and J.R.

Commons, the founders of Institutional Economics. Meanwhile, according to Carlsson-Wall [5], the new Institutional Economics is closely associated with the names of D. North, O. Williamson, R. Pozner, R. Coase and focuses on the analysis of institutions as a set of legal norms and informal rules that determine the economic behavior of an individual and organizations (entities).

The new Institutional Economics has quite a few different names, i.e. neoinstitutionalism, as a derivative of institutions, but with due account of newly introduced aspects; or transactional economics, as associated with transactions and transaction costs; or economic theory of property rights, as the most important component of the new doctrine; or contractual approach since the new institutional economics interprets activities of all organizations as a synthesis of explicit and implicit contracts [33]. Therefore, one can say that neoinstitutionalism can be understood and described as an integration of different approaches united by a number of shared visions.

According to Chen [6], institutions as components of the institutional environment are "the rules of the game" in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange and reduce uncertainty by providing structure to everyday life, define and limit the set of choices of individuals.

Institutions are forms and frameworks of human activities, represented by political organizations, forms of business, systems of lending agencies, tax and financial laws, business administrations, and many other economy-related regulations. The very sense of using the institutional approach in an analysis is to go beyond pure economic categories and processes and to take into account institutions and the global business environment. As noted by Lehoux [22], the difference between the modern "institutions" and the historical "institutes" (i.e. laws, which are studied by legal scholars, and customs and traditions, which are studied by anthropologists and ethnographers) is that an institution is an inseparable unity of formal and informal rules.

Institutions or the institutional environment include both global (formal) rules and informal restrictions, as well as certain forms of enforcement to ensure compliance with both. Therefore, we can say that institutions are represented in society by two large groups, i.e. formal and informal institutions, where the latter appear first as a cultural heritage developing from the people's social intercourse.

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# Institutional Environment of Internal Controls in Autonomous Establishments

Informal institutions, in turn, are represented by standards and rules of behavior that are mandatory both in society and in business. Political institutions are understood as a network of organizations and entities that represent social governance and include the institutions of authority and civil society. Economic institutions, unlike political ones, regulate business processes in organizations and enterprises by means of laws, regulations and other regulatory documents. One of the main regulations is the property right that applies to legal entities and individuals with regard to real estate, land, and movable property.

## II. METHODS AND MATERIALS

### A. GENERAL DESCRIPTION

The institutions of contracting determine the rules of arrangements between two (or more) economic agents, i.e. between the buyer and the seller by means of agreements on prices, assets, and guarantees (insurance, collateral, etc.). It should be noted that the property right and the institution of contracting are the basic and most significant institutions in the institutional setting of any economic system of a country (community), region, and economic entity.

Thus, the existing rules can be interpreted as contracts, but then we need to determine the levels at which these formal rules or institutions are created.

Based on the institutional environment of an economic entity, including an autonomous establishment, in which the entity operates and the formal rules apply, two levels of formal institutions should be distinguished - external and internal:

1) The external level in relation to an autonomous establishment is understood as the formal rules that are established at the state (federal, regional, municipal) legislative level and determine the fundamental operating procedures for the establishment (e.g. the institution of property).

2) The internal level in relation to any organization, including autonomous establishments, is understood as the formal rules represented by bylaws that are developed in the autonomous establishment itself, and without which no transactions are possible.

These levels show that the primary source of such rules is the state (community) [30], from which they descend to the level of an economic entity (autonomous establishment) and then reach a specific contractor or, in other words, an individual contract.

According to the authors, informal rules, unlike the formal ones, cannot be arranged in a hierarchical structure, however, they further develop into internal and external rules and procedures applicable to an entity (autonomous establishment) [20]. For example, relations between employees and those with partners are also based on rules, such as respect, commitment, avoidance of abuse of power, aggressive or bad mood attitude, etc.

Such formal and informal institutions determine the need for the creation and development of special structures for integrating "certain" "specific" rules and creating means for their implementation, i.e. organizations, enterprises, establishments [7]. However, at a certain stage of their

existence, the structures themselves start to dictate the terms and conditions for changing and reshaping such institutions, with due account of the changing institutional environment.

### B. ALGORITHM & FLOW CHART

Institutions are not rigid structures. The differentiation of the institutional setting at different stages of its evolutionary development is driven by changes (specifically, those affecting the governance at various levels) aimed to solve the emerging economic problems. The evolutionary impact on the development and change of the institutional environment can be shown through the example of the Russian Federation development in the post-Soviet period [32]. From 1991 till 1997, the institutional environment in Russian was far from perfect due to the lack of necessary regulatory framework, outdated methods of command management, lack of qualified managers, which often led to rapid bankruptcy and dissolution of a business. From 1998 till 2005, the institutional setting in the Russian Federation changed a lot: a few legislative acts were adopted to create a comprehensive system that would govern Russia's international economic affairs and the economy in general. These include the Budget Code, the Tax Code, chapters 3 and 4 of the Civil Code of the Russian Federation, the Customs Code of the Russian Federation, the Laws "On the Customs Tariff", "On Currency Regulation and Currency Control", "On Foreign Investments in the RSFSR", "On Excise Taxes", "On State Regulation of Foreign Trade", "On Measures to Protect the Interests of the Russian Federation in Commodity Trade", "On Export Control" [15]. Further on, in the years that followed, including the present day, the Government has been implementing the policy aimed to improve and develop the institutional environment in Russia in general, which, in turn, determines the institutional setting of economic entities [27]. The type (nature) of the institutional environment specific to each economic entity determines the manner of interaction between the stakeholders, the pattern of the relationship between the organization (entity) and the external environment, with due account of the macro level setting.

Based on the analysis of institutes and institutional environments, the authors developed a diagram representing the institutional setting of an autonomous establishment, see Figure 1.

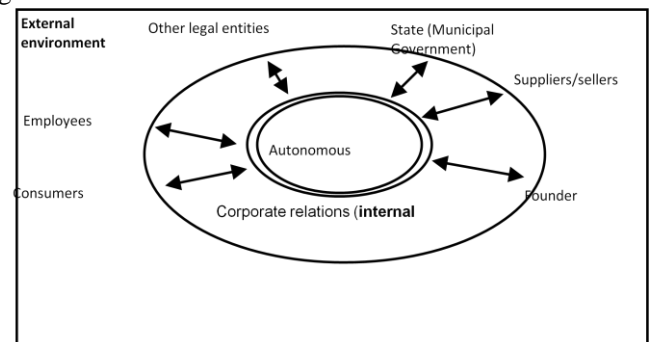


Figure 1. Mechanism of the institutional environment of an autonomous establishment



According to Figure 1, the institutional environment of an autonomous institutional involves economic agents, i.e. consumers of services (works) rendered by the autonomous institution; suppliers (sellers) of materials and equipment; the state (municipal government) by means of assignments; employees and the founder of the autonomous establishment; and economic entities, i.e. other legal entities and individuals. Therefore, the institutional environment is a set of economic, social, legal, political (formal and informal) rules aimed to balance human incentives and contribute to the ultimate agreement between people.

### III. RESULTS

The institutional environment of an organization, including an autonomous establishment, is a set of formal and informal rules that determine the relations between the autonomous establishment and buyers (consumers) of services and work provided by such establishment; between the autonomous establishment and sellers of materials and equipment; between the autonomous establishment and the state (municipal government) regarding the implementation of the government's assignments; between the founder and the autonomous establishment; between employees and the management of the autonomous establishment. Based on the institutional concept and model of audit proposed by J. Church [7], one can reasonably assume that the institutional approach sees internal control as an institution, i.e. a set of legal norms, rules, standards, concepts, and implementation mechanisms, in the context of an economic entity. From this perspective, the institution of internal control can be most likely understood as a set of principles, methods, objects, basic categories, and requirements within the institutional environment of an autonomous establishment's internal controls. The institutional environment of an autonomous establishment's internal controls includes two levels, i.e. the external institutional environment and the internal institutional environment of internal controls.

The external environment of an autonomous establishment's internal controls, i.e. the legal framework, is represented by formal and informal institutions. The main formal institutions of the external institutional environment of internal controls are as follows:

- international standards of internal controls;
- Russian practice, limited to federal law No. 402-Φ3 of 6 December 2011 "On Accounting", as well as federal accounting standards for public organizations (establishments), clarifications of the Ministry of Finance of Russia regarding the organization and implementation of internal controls of business operations by economic entities, and regarding accounting and preparing financial statements by business entities. It should be noted that the external institutional environment of an autonomous establishment's internal controls is represented primarily by federal laws, regulations, and standards that establish the rules of internal control. Whereas the formal institutions within the internal environment are represented by local (in-house) bylaws that govern the internal control processes in the establishment. The practical manifestations thereof are the charter of an autonomous establishment, regulations on internal control or

the internal control function, the rules of interaction between the internal control function and other functions of the establishment in relation to internal controls, and, accordingly, the rules of interaction between employees of the establishment, etc.

### IV. DISCUSSION

In the global accounting practice, the institutional environment of internal control is studied in the context of institutionalism or institutional economics, where the main categories are mainly "institutions" that are understood as a set of legal norms and informal rules that determine the economic behavior of an individual and organizations. Meanwhile, according to Dharmapala and Riedel [14], the institutional environment is a set of external factors that influence business entities through the operation of a number of political, economic, social and other institutions. In that context, the institutional environment can be defined as a set of formal and informal rules (institutions) aimed to balance human incentives and contribute to the ultimate agreement between people. According to Lefler and Gabler [21], informal institutions are represented by standards and rules of behavior that are mandatory both in society and in business. It should be noted that informal institutions are not some rigid dogmas set at a specific period of time and maintained through the ages; these are rules, codes, and standards that evolve and adapt together with the social and economic development of the society. Examples of informal institutions are ethical and moral standards of human behavior, such as honor, conscience, decency, responsibility, which also form the basis for and govern the corporate culture and code of conduct between employees and everyone in an organization. In contrast to informal rules, the formal ones (institutions) are shaped as regulatory instruments and include political, economic institutions and contracting systems (laws and regulations governing the conclusion of contracts).

In the papers of Zain [35], Davidov [12], and later practical papers [25, 17, 26, 4, 13, 19], the institutional environment of an economic entity is divided into two levels, i.e. the external and internal institutional environment, where the external one, consisting of formal and informal institutions, prevails and influences the internal one, consisting of its own specific cultural and functional "micro-institutes" (both formal and informal). The most important formal institutions that shape the external institutional environment of an economic entity, are as follows:

the institution of law that governs the legal relations between citizens and organizational structures of an economic entity in any economic activity and/or provision of services [16];

the institution of property that governs the relations between consumers of products (works, services) and their producers in the sale, i.e. change of ownership, of such products [10];

the institution of markets that governs the relations between economic agents, i.e. producers, intermediaries (trade), the government, and consumers in the exchange of goods, services, resources [9];

the institution of finance that governs the monetary relations between economic entities (producers of products, works, services) and lending agencies in the country [23];

the institution of taxation that governs the legal relations between economic entities (producers of products (works, services)) and the government in payment of taxes and fees [18];

the institution of transfers that governs the relations between economic agents –economic entities (producers, intermediaries), people and the government in the redistribution of incomes of the consolidated state budget [23];

the institution of foreign trade that governs the relations between producers of products, works, services and the global economic system in the production and sale of products, works, and services [11].

Meanwhile, in examining the factors of the external institutional environment that significantly influence the development of the internal institutional environment of an economic entity, the following factors should be emphasized: the institution of taxation, the institution of transfers [34], the government's budget and tax policy, the institution of market [3], including the mechanisms of the government's regulation of market relations, as well as various formal and informal rules and agreements on the regulation of individual markets.

## V. CONCLUSION AND RECOMMENDATION

Based on the outcomes of this study, the following conclusions can be drawn:

1. The efficiency of internal controls depends on the maturity of the institutional environment of the economic entity (autonomous establishment); such maturity is determined by the degree of involvement of formal and informal institutions in relations between economic agents, economic entities within such institutional environment.

2. According to the institutional approach, the institution of internal control of an economic entity (autonomous establishment) is a dual system, i.e., on the one hand, it is the main institution within the institutional environment of an organization (autonomous establishment), and, on the other hand, the main institution itself includes derivative formal institutions of law, represented by concepts, norms, rules, standards.

3. The institution of internal control of an economic entity (autonomous establishment) can be understood as an institutional model that includes the main institution of internal control itself, derivative institutions (standards, laws, regulations), principles of internal controls, an institutional mechanism (tools) and elements of the institution of internal controls.

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