The Role of Independent Directors and Audit Committee in Corporate Governance--- A Case Study of Enron Corporation

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ABSTRACT
This work examines the effectiveness of audit Board and Independent Directors, focusing on their responsibilities in reporting. In particular, it uses a comprehensive institutional perspective to incorporate the dynamics of institutional formers and organizations and identify issues arising from the introduction of internationally accepted governance mechanisms. The findings show that institutional environment does not yet fully support the concept of imports. The implementation of audit committees and independent directors seems to be largely symbolic, as these concepts are rarely as a tool to improve the quality of reporting. They also showed how conflicting institutional pressures form a loose bond between regulation and actual operation, intertwined with conflicts of interest and power dependence of organizational participants in institutional environment.

Keywords: *Audit Board, Independent Directors, Corporate Governance*

1. INTRODUCTION

The main aim of this chapter is to create an awareness of what constitutes good corporate governance – how to achieve it, the threats to achieving it and the role of independent directors and auditors [1].

1.1 Theoretical underpinnings

(a) In their overview of the development of institutional theory, DiMaggio and Powell (1991) differentiate between old and new institutionalism. In old institutionalism, organizational structure and changes were mainly shaped by the values, alliances and power relations of competition within the organization frameworks. The old institutional theory focused on the importance of the existence of internal rules, the Norms and conventions in the design of the change process. It shows that the exercise of group interests in the organization can lead to actual organizational practices deviating from those expressed[1]. New institutional thinking emphasizes the role of environmental forces in shaping and constraining organizations. This view assumes that organizational practices, including corporate governance structures, are profoundly influencing Be influenced by broader social and cultural backgrounds (Dobbin, 1994) Organizations operating in similar environments should have similar characteristics, including internal structures and procedures that society deems appropriate. From this perspective, there is an organization that legitimizes its activities by adapting to external constraints, rather than improving the internal efficiency of announcing the acceptance of certain institutional agreements[1].

(b) The new institutional theory is widely used to analyze the isomorphism of organizational practice (Lounsbury, 2008). However, it has been criticized for its typical “macro” focus on the impact of the institutional setting and lack of insight into the internal dynamics of the organization (Greenwood and Hainings, 1996; Moore, Burns and Major, 2006). Oliver (1991) also pointed out that organizations do not passively adapt their formal structure to the requirements of external bodies. Similarly, Scott (2008) pointed out that this view

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believes that the institutional setting is "an environment that imposes requirements and / or constraints on the organization ... which implies a top-down view" (p. 429 -30), and The System Requirement is "subject to interpretation, manipulation, revision and elaboration by the subject" (p. 430)[2]. Selznick (1996) believes that drawing a clear line between old and new institutionalism will inhibit the contribution of institutional theory to important issues such as bureaucracy and social policy. Some institutional theorists such as Moll et al. (2006) Call for a fuller understanding of the creation, continuation, and abandonment of the system and the interactive nature of the system process.

(c) It is consistent with the views of Selznick (1996) and Moll et al. (2006). This research takes a broad perspective and combines the ideas of old and new institutionalism. Therefore, it combines the power of the old institutionalism in examining the value of internal competition, alliances, and power relations, with the new institutionalism that emphasizes the importance of examining the setting of external institutions. The research focuses on the interaction between internal and external forces to understand how the concepts of AC and ID play a role in the context. In particular, this study examines the interaction between audit committees, internal auditors, and key organizational participants (such as managers, internal and external auditors, and external agency forces), and provides an insight into the implementation of British and American concepts. Problem insights. From a broad institutional perspective, she comprehensively analyzed the institutional background and internal organizational dynamics, as well as the interests and power relationships of related parties. These factors are the factors that affect the implementation of these concepts.

2. THE PURPOSE AND SIGNIFICANCE OF STRENGTHENING THE REGULATORY ROLE OF INDEPENDENT DIRECTORS AND AUDIT COMMITTEE IN CORPORATE GOVERNANCE

2.1 Purpose and significance

The purpose of strengthening independent directors and audit committee in corporate governance is as follows

(a)Because independent directors represent a position independent of the company's shareholders. Independent directors and audit committees can usually objectively use their ability to manage the adverse behavior of controlling shareholders to the company.

(b)Because people who can serve as independent directors or members of audit committee usually have high professional quality and educational background. It can make the operation of the company more professional and make the internal operation of the company more efficient.

(c)The audit committee has the power to review and report the financial statements, so it can ensure the accuracy of the company's internal financial information[3]. The existence of the audit committee can convince investors of the information and data released by the company. Effective audit committee supervision is a process that can protect investors and the normal operation of the capital market

2.2 Insufficient

From the end of last century to nowadays, the CSRC has successively issued several policies and regulations on the establishment of independent directors. The number of independent directors is also increasing with the development of economy. By 2001, there were 314 independent directors in the securities market. Unfortunately, due to the imperfect development of this system, people find that there are still many deficiencies in the implementation of this policy.

2.2.1 Institutional aspects

(a)In China, the ownership of stocks is concentrated in the hands of some people, so the board of directors with most rights will be assigned to some legal representatives, resulting in a serious phenomenon of "insider control". It can be found that under such a situation, the audit committee can not play its due functions.

(b)Because the independent director system and the audit committee system do not have enough legal support, this also leads to the lack of legal protection of independent directors. In such a case, some positions of independent directors may be obtained by virtue of their relationship with leaders. What's more, in the absence of legal protection, even if some independent directors fail to perform their due duties, there are not enough laws for people to investigate their responsibilities.

2.2.2 Market conditions

(a)There are not a large number of training institutions in the market, and there are very few talents who are really capable of acting as independent directors in the society. Without a lot of ability to manage the company and judge, some independent directors will be unfair in judging things.

(b)The personal reputation and professional evaluation system in the market is not mature. Therefore, it is difficult to see a comprehensive and fair evaluation of independent directors.

2.2.3 Internal aspects of the company

(a)There is no organization for independent directors to play a role in the company, and the rights of independent directors are nominal. This is because the board of directors of the company did not grant independent directors the decision-making power they should have. According to foreign experience, independent directors should establish some committees dominated by independent directors. Audit, nomination, compensation and other committees. However, the board of directors of most listed companies in China has not established any committee dominated by independent directors. As a result, the independent directors have no real name and can not play the supervisory role of controlling shareholders and executive directors.

(b)The proportion of independent directors in the board of directors is too small, and only a few companies will grant independent directors sufficient decision-making power.

(c)Most listed companies lack effective incentive mechanism. In detail, in addition to honorary incentives, there are not many substantive remuneration, so most independent directors do not have enough enthusiasm for supervision.

2.3 Improvement methods and policies

2.3.1 Institutional aspects

(a)At the institutional level, social and judicial institutions should make every effort to protect and adjust the equity structure of listed companies and prevent the phenomenon of equity concentration.

(b)On the one hand, relevant departments should improve the policies and regulations on the independent director system. On the other hand, we should standardize the internal basic law of listed companies and add treaties on independent directors.

2.3.2 Market aspect

(a)Cultivate the human resource market of independent directors and establish a perfect independent director system.

(b)We should not only retain the due honor and reward for independent directors, but also increase the substantive incentive mechanism.

(c)Establish the supervision and restraint mechanism and responsibility mechanism for independent directors.

(d)Establish institutions related to the evaluation of independent directors and establish binding and regulatory provisions for independent directors.

In our paper, my classmates and I want to take Enron company as an example to discuss the role of strengthening independent directors and audit committee in corporate governance supervision in the Enron incident.

3. ANALYSIS OF ENRON

The Enron incident not only made Enron company bankrupt, but also directly led to the disintegration of Arthur Anderson, one of the world's five largest accounting firms, which also shows the importance of using reasonable audit means to supervise the company in corporate governance. Enron's bankruptcy has great influence, and its fraud process is more hidden, which is worthy of in-depth discussion. The data of this paper comes from news and online media.

3.1 Review of Enron Corporation

In 2000, Enron's total revenue was as high as 101 billion US dollars, ranking seventh in the "Fortune 500" magazine. Its business covers more than 40 countries and regions in the world, with assets of 62 billion US dollars.

However, in October 2001, the transaction between Enron and two affiliated enterprises was disclosed by the media, and the Enron incident broke out.

In November 2001, Enron admitted to the US Securities Regulatory Commission that it had made false accounts: between 1997 and 2001, it falsely reported profits of US $586 million, and did not record huge debts. In the same month, the securities rating company rated Enron as a junk stock, the market value of $60 billion disappeared, and Enron employees lost $2 billion in pensions. In December of the same year, Enron applied to the court for bankruptcy protection, becoming the largest bankrupt enterprise in American history at that time.

On New Year's day in 2002, the New York Stock Exchange announced that Enron would be removed from the Dow Jones industrial average.

3.2 Event analysis

3.2.1 Business practice analysis

a. Use "special purpose entities" to overestimate profits and underestimate liabilities.

Enron improperly used the accounting practice that "special purpose entities" could not be included in the consolidated statements once they met specific conditions, and excluded the three "special purpose entities" (Jedi, chewco and ljm1) that should have been included in the consolidated statements from the preparation scope of the consolidated statements, resulting in an overestimation of profits of US $499 million and an underestimation of liabilities of US $hundreds of millions from 1997 to 2000. In addition, on the ground of not conforming to the principle of "importance", Andersen's audit adjustment suggestions were not adopted, resulting in an overestimation of net profit of US $92 million from 1997 to 2000.

b. Overestimate assets and shareholders' equity by hanging notes receivable empty.

Enron established four "special purpose entities" (hereinafter referred to as class V companies) named raptorI, raptorII, raptorIII ~ raptorIV respectively in 2000 to hedge the market risks invested by Enron. In order to solve the capital problem of class V companies, Enron issued $172 million worth of common shares to class V companies in the first quarter of 2000. Without receiving the subscription payment from class V company, Enron still recorded it as an increase in paid in share capital and increased notes receivable accordingly, thus falsely increasing assets and shareholders' equity by $172 million. According to the accounting standards, this transaction should be regarded as the arrears of shareholders as a deduction of shareholders' equity.

3.2.2 Analysis on Influencing Factors of audit quality

a. Defects of corporate governance structure

The separation of ownership and management rights will inevitably lead to serious information asymmetry between investors and management of listed companies. Information asymmetry is one of the incentives of accounting fraud, and may bring adverse selection and moral hazard. The Enron incident shows that independent directors are not omnipotent. Among the 17 directors of Enron, 15 are independent directors. Among them are the former dean of Stanford Business School, the former Secretary of energy of the United States and so on.[4] This large group of professionals said that the technical reason why accounting fraud could not be investigated was obviously unreasonable. The most likely reason is that some of them were also involved. The fact is that when the management announced to the outside world that the stock price of Enron would still rise, some directors were secretly selling Enron's shares. It is obvious that they already knew that the company had problems, and the financial reports provided by Enron to the market were still prosperous at that time. Enron's board of directors not only failed to fulfill the obligation of internal control, but was the culprit of fraud. The charges they faced included negligence, false accounts, inducing investors and seeking private profits.[4]

b. Negligence of external audit

Andersen, who is responsible for providing audit assurance and consulting services for Enron, is to blame for its fraud. Andersen not only provides audit and assurance services for Enron, but also provides high-income consulting services. Enron is the second largest customer of Andersen. Andersen not only provides audit services, but also is responsible for issuing financial and accounting statements. Andersen even charged more for non audit services than for audit services. At the same time, many senior managers of Enron were former employees of Andersen. Their close relationship at least undermines Andersen's formal independence. This is also a major cause of audit failure. When the income of accounting firms comes from well paid consulting services, it is obviously impractical to expect them to remain detached and independent when auditing the financial statements of these clients.

c. Deficiency of internal control

Although Enron has a board of directors and an audit committee, they have failed to play their due role and functions. Moreover, the company adopts the stock incentive mechanism, which is very common in American Enterprises - stock option incentive will be given to employees and management according to the company's performance. As a result, some managers in the company seek to maximize their own interests at the expense of the interests of others. Continuously modify the company's financial status, operating results and cash flow, deliberately conceal or cover up the company's possible major problems, resulting in the low audit quality of certified public accountants.[5]

3.3 Enlightenment of Enron incident

3.3.1 Internal corporate governance

a. Independent directors

For a company, independent directors are expected to play the role of supervising the operation of the company. Such supervision is conducive to the long-term development of the company, and prevents the management from damaging the profits of the company in pursuit of their own interests. However, in reality, the role played by independent directors is far from what people expected. It can be seen from the scandal of Enron that the independent directors of Enron have played a vital role in accounting fraud. If they can strictly perform the role of supervision, such illegal profit-seeking events can be largely avoided.

b. Audit committees

At the same time, the internal audit of the company is also essential for the healthy operation of the company. The audit committee of a company is chaired by independent directors, and the duties of the above-mentioned independent directors are also very important in the audit committee. Internal audit can make the problems in the company be found in the first time, which can avoid the further expansion of events. In other words, internal audit is a process of self-correction. If a company's internal audit loses this function, many mistakes in the company's accounts will probably be ignored, and many mistakes may be made by the managers deliberately, so as to seek illegitimate profits. As in Enron, such mistakes pushed the company into an irreversible position.

c. Internal control

To sum up, for the corporate governance of a modern company, it is crucial to establish a strict and reasonable internal control system. Firstly, the company needs to have a strict internal control procedure. An effective program can avoid mistakes within the company to the greatest extent. This means that only by limiting the possibility of errors in the process can the number of errors actually occurring within the company be fundamentally reduced. Secondly, the company needs to strictly perform the implementation of its internal accounting system. Recording accounting accounts according to laws and regulations, so as to avoid making false accounts within the company. Finally, the company should establish a law-abiding, healthy and progressive corporate culture environment. A good corporate culture atmosphere is conducive to the active work of employees, and can reduce the occurrence of dereliction of duty and self-interest.

3.3.2 Outside audit

In many cases, it is very difficult to guarantee that the company will not commit fraud, false accounting, insider trading, etc. Therefore, it is particularly important for the external audit to supervise and restrain the company. In the Enron scandal, on the one hand, Andersen, who is responsible for the external audit of Enron, also provided consulting services for Enron. On the other hand, many Enron employees are inextricably linked with Andersen. This leads to the deep interest binding between Enron and Andersen, which makes Andersen lose the independence of external audit.

Therefore, we can conclude that it is crucial to ensure the independence of external audit. In order to achieve this, it is necessary for the state to formulate corresponding laws and regulations to limit the excessive intimate relationship between companies and accounting firms. Only in this way can the accounting firm be restricted from colluding with the company for profit, operating illegally, damaging the interests of shareholders and investors of the company, and disrupting the normal market order.

3.4. Sarbanes-Oxley Act

After Enron scandal, the American government enacted Sarbanes-Oxley Act to avoid similar incidents. This bill strengthens the restriction on the internal control of the company in the form of law. At the same time, the bill also restricts the external audit, so that the accounting firm that provides consulting services to the company can no longer provide audit services to the company. This bill restricts the defects in the internal governance and external audit of companies analyzed above in the form of law, which is conducive to the healthy development of companies and capital markets in the future.

4. CONCLUSION

Taking Enron Corporation as an example, we analyzed the best use of independent directors and audit committees in corporate governance. The analysis shows that although independent directors and audit committees are essential to the internal supervision of the company in theory, in practice, more corporate systems and legal constraints are needed to supervise the implementation of this internal supervision process, otherwise it will easily lead to internal fraud, insider trading and false accounting. In addition, we also found the importance of external audit to restrict the legal operation of the company. On the one hand, these problems can be restrained by the Sarbanes-Oxley Act and other provisions in the form of laws. On the other hand, it is worth more research and discussion in the future on how to restrict the occurrence of illegal activities by formulating internal rules and regulations.

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