ISSN 2616-5902 Vol. 5, Issue 12: 10-14, DOI: 10.25236/AJBM.2023.051202

Research on the impact of corporate governance on enterprise bankruptcy risk

Jing Zhang

Lyceum of the Philippines University, Manila, Philippines

Abstract: *This article research on how corporate governance affects enterprise bankruptcy risk from the perspective of decision-making, audit management and risk prevention. This article analyses the results in multiple cases to analyse the bankruptcy of a company due to corporate governance issues. This research discusses the following three points. First, directors' decisions play a crucial role in the company's operations. Second, managers must conduct audit management of the company because staff members may ignore accounting standards and implement accounting fraud, making false descriptions of income and expense omissions. Third, risk prevention requires directors to accurately assess conflicts of interest, long-term contracts and participation risks, and future cash flow shortfalls when the company faces legal risks.*

Keywords: *Corporate governance, Enterprise bankruptcy risk, Decision-making, Audit management, Risk prevention*

1. Introduction

This article is going to address the reasons for not controlling corporate governance risks and causing bankruptcy. Corporate governance risk is defined as the irrational design of corporate governance system or the imperfect operating mechanism of the company's continuous operation and its impact on the total value of the company, thus threatening the interests of investors (Cassidy, 2003)[5]. This kind of threat is manifested in many aspects. The existing literature tends to find the interaction of many risks gradually accumulates, which may eventually lead to a total outbreak such as company bankruptcy. However, risk is the uncertainty that the company faces in its business processes. It may bring opportunities to realize the company's business objectives, and it may also cause damage. Through many studies, it can be found that the main concern is the negative impact that may be taken to the company's goals in the risk management of corporate governance. Next, this article will focus on the following three significant aspects to analyses and summaries.

2. Three aspects of the corporate governance

2.1. Decision-making

In a market environment, decisions about a business or organization often lead to a series of social and economic consequences. Managers' decisions can have an immeasurable impact on their organization's members. Whether the decision of the manager is correct or not often determines the rise and fall of the enterprise or organization. Nobel laureate Robert Simon once wrote that management is decision-making, and decision-making is the core of management (Eastwood et al., 2011)[8]. The level of decision-making has a huge influence on the success or failure of a company.

First at all, according to estimates by the US RAND Corporation, 85% of the world's bankruptcies are caused by leaders' decision-making mistakes (Del Missier et al., 2011)[7]. For example, Google's decision to withdraw from the Chinese market was a failure (Tuckett, 2018)[13]. From the whole incident, the company's decision makers lacked respect for the host country's regulations, overestimated the company's market influence, ignored the determination and ability of the home government to support its Chinese government, and miscalculated its energy from Chinese fans. Google's market share is no more than half of Baidu's. Its exit has no real impact on China's online search market. Moreover, they have seen that search engines such as Sogou are actively acting to fill the market space left by Google. However, the mistakes made by Google and other companies, and their root causes deserve our careful consideration.

ISSN 2616-5902 Vol. 5, Issue 12: 10-14, DOI: 10.25236/AJBM.2023.051202

A well-known management expert at the Massachusetts Institute of Technology believes that there are three aspects that are core competencies in terms of its comprehensive quality for leaders. The most important aspect is decision-making accounting for 47% (Xia et al., 2015)[15], followed by management skills and professional. Due to the considerable risk of the modern investment market and the requirements of standardization and demonetization of decision-making, many large financial companies in the world have implemented group decision-making systems, such as a board system or committee system.

However, for an organization, it is often the case that group decisions will fall into the domination of a few people. For instance, after analyzing the organizational structure and decision-making processes of CITIC Limited, it is easy to find that the company has obvious characteristics that are dominated by a few people. On the one hand, Zhijian Rong is in the third generation of the family business and is also the founder of CITIC Limited (Avrichir et al., 2016)[1]. This particular background has created a special power discourse about the company's major investment decisions, which in some ways can influence and dominate the thinking and attitudes of other decision-making members in the business group. On the other hand, the top executive of CITIC Limited has obvious cohesion, that is, the degree of direct attraction of the main decision-makers is very strong, leading to a loss of control over the supervision of individual decision-making power.

As Napoleon also said, the ability to make decisions is the most difficult to obtain, and therefore the most valuable (Randall et al., 2006)[10]. Business managers must make decisions every day on the various issues facing the company. In a complex and volatile environment, managers must make decisions that affect the fate of individuals and companies in situations where information is inadequate and uncertain. In this case, the decision-making psychology and behaviour of individuals and groups has an intangible and significant impact on decision-making.

Therefore, it is concluded that the market is like a battlefield without smoke, while the competition within the same industry has developed to a feverish degree. Whoever is good at planning and management is likely to take the lead in the market, seize the commanding heights, and maintain the outcome of never falling behind the market.

2.2. Auditor management

Auditor management plays a vital role in corporate governance and owes a professional responsibility to the company's shareholders and to society. Because the auditors are the key people in charge of auditor management, they should provide true and fair views of a company based on their profession's guidance to help the company operate efficiently and profitably. However, nowadays, some companies ask auditors to use 'creative accounting' to show artificial financial results in their financial reports (Smale, 2019)[12]. Due to the pressure of economic before false reporting thus breaking competition, companies may magnify profits providing stockholders with accounts which look better than true accounts. This can amount to accounting fraud resulting in corporate fraud.

This accounting fraud is a problem caused by loopholes in audit management as well as a kind of corporate fraud which leads company sectors to cheat stockholders, forgery and destroy evidence. All of this equates to criminal breach of trust. The Indian company called Satyum used accounting fraud and ignored ethical consideration to show a good financial position as described in an article in the Amity Business Review (Brown et al., 2014)[4]. The second company, Enron, was shown in the Journal of Business Ethics, to have moved the debt off their balance sheet before false reporting thus breaking to benefit to company's advantages (Shirur, 2011)[11]. These two cases both involve ignoring accounting principles and committing accounting fraud to make private profits and cheat stockholders, resulting in breaking laws and bankruptcy.

In Bharir's article, he describes how Satyum in India used accounting fraud to fake figures in order to hide the low value of their assets thus by increasing their share price enabling the shares to be sold at a profit through 'creating accounting' practice by creating fake invoices and bank balance sheet which finally converted into cash receipts. Due to this reason, the company's share price increased. This illegal and unethical behaviour leads their company's share price to decrease dramatically, wiping out Rs.9376 belongs to investors' wealth during the only one day.

Unlike Bharis, Rockness describes how the American company, Enron, ignored accounting principle and made accounting fraud by moving debt off their balance sheet resulting false account to gain company's own advantage of senior management accountant. The number of participants in this event was large as not only the CEO of firm designed this plan, but also accountants with the illegal

ISSN 2616-5902 Vol. 5, Issue 12: 10-14, DOI: 10.25236/AJBM.2023.051202

operations based on full knowledge of accounting fraud. It was sad that some lower executives tried to below the issue and stop the illegal development. However, the external auditors of the company ignored them. Moreover, the relevant transactions were recorded incorrectly, and the CEO, CFO and other key people of the company encouraged staff to conceal the illegal acts, which progressed to fraudulent reports. Finally, Enron's accounting for the stock price in exchange was called into question resulting in the destruction of documents. The result of that was a large corporate bankruptcy.

Based above of this, it is obvious that the sectors in supervision department failed to take responsibility for correcting the company's illegal acts. Moreover, the accounting structure in a company should be noticed because they lose professional ethics and ignore accounting principles to assist a company to take advantage. Due to this reason, the government should reform the whole accounting structure unless the accounting fraud appears again, robbing assets from bank and stockholders. And accountants as well as auditors should be unshaken and brave while they are required to operate accounts and hide the true account. Fortunately, the government re-wrote the tight principle of accounting and audit. In addition, the top management is a factor of bankruptcy as they attempt to make illegal income and incite accounting divisions to operate accounts. Due to this reason, it is necessary for companies to change aboard when they see the signs of accounting fraud. The government also can take control of the company and choose the board on their behalf.

2.3. Risk prevention

Failure of corporate risk prevention may accelerate the bankruptcy of the company. The three points are: first, shareholders fail to assess the legal risks from conflicts of interest, second, shareholders fail to assess the risks of long-term contracts and participation in risky projects and third, shareholders failed to assess the risk of insufficient cash flow in the future. The company's board of directors has the principal responsibility for assessing the associated risks. If a director privately uses his authority to commit fraud, the director will be subject to criminal penalties (Brisset, 2016)[3].

Firstly, many companies use earnings management as a solution to solve growth problems in their operations. For example, companies use related operational behaviours to boost revenue and downgrade expense, in order to achieve income smoothing and tax avoidance (Perols & Lougee, 2011)[9]. When earnings management becomes a manager's false manipulation, it will involve legal issues. Earnings management may distort the company's operating performance, which may lead to accounting information losing its objectivity and neutrality, and misleading stakeholders' decisions. Several studies have found evidence to support the reason company managers manage earnings is to improve their own compensation, affect the stock market's understanding of the company's performance, reduce debt default risk, plan tax, and avoid government intervention. Perols and Lougee (2011)[9] examined the relationship between earnings management and financial statement fraud and found that fraudulent companies were more likely to achieve earnings management in the past few years and that earnings management in previous years was associated with a higher likelihood of meeting or exceeding Analysts' predictions or exaggerating revenues.

Secondly, a company's signing of a third-party contract under the premise of concealing the board of directors also can be one of the reasons for the failure of risk prevention. Dechow and others (2011)[6] explained how irregularities such as off-balance sheet items can be easily considered as one of the risk factors for bankruptcy. This is since the company fraudulently invests in promising contracts, but the auditor cannot track documents. Widhoyoko (2017)[14] studied the relationship between off-balance sheet financing and risk aversion and found that companies adopting fraudulent practices used the following three methods to deceive investors: "(1) engaging with double-signed contracts; (2) engage with unfavourable contracts to attract third parties and (3) engaging undisclosed sell-back contracts." (p. 36). The purpose of these methods is to defraud investors of potential long-term projects while investing the funds in other projects. In addition, Samuel's results show that when the purpose of such accounting manipulation is fraud, it will lead to increased financial risk for the company and consequently increase the debt ratio. There is direct evidence that off-balance sheet financing projects may lead to an increase in enterprise bankruptcy risk by examining the case of Enron. Enron's details on transactions with off-balance sheet financing entities are described in Baker and Hayes (2004)[2]. Their off-balance sheet financing transactions do not fully or clearly convey the nature of the transaction and do not reflect the substance of what happened between Enron and the partnerships. US Senate Chamber of Commerce member Senator Fitzgerald once stated that he quickly became convinced that Enron's off-balance sheet financing operations would only fictitiously increase profits (Baker & Hayes, 2004)[2]. With the partnerships having no other economic purpose.

ISSN 2616-5902 Vol. 5, Issue 12: 10-14, DOI: 10.25236/AJBM.2023.051202

Thirdly, exaggerations of income and assets, as well as cost and debt omissions, are types of financial statement fraud that plays a role in enterprise bankruptcy risk. False accounting operations may expose the company to financial risks, including breaking the company's capital chain, which inform hinders the company's project operations increasing bankrupt of risk. Moreover, simply exaggerating assets and income will not make up for the company's losses. Because companies must pay for operating expenses and unfinished projects, even while exaggerating assets and revenues, it may result in insufficient cash flow in the future.

Finally, based on these scenarios, it can be concluded that a company can avoid the risks of conflict of interest in law by strengthening external supervision, ensuring the signing of correct long-term contracts, reduce participation in risky projects, and manage cash flow to ensure the company's good sustainable development, thus reducing the risk of bankruptcy.

3. Conclusion

This article is focused on the three factors of corporate governance, resulting in enterprise bankruptcy risk. The most compelling evidence suggested that the main factor is decision making, followed by auditor management and risk prevention. Because decision making often leads to a series of social and economic consequences and makes an immeasurable effect on the organization. The article suggests that the right decision can keep a company ahead and never behind in the market thus it is necessary for decision maker to have not only judgement ability, but also a cohesive and special speaking rights. To some extent, discourse power can directly influence and determine the thinking as well as attitudes of employees.

There are some limitations in this article. Laws in different countries may lead to disputes and loopholes for companies to gain personal benefits when they sign contracts. At the same time, the accounting standards in different regions will also urge the company's top executives to generate the idea of using the loopholes to seek black income. Due to this reason, Companies need to be in the same legal provisions and accounting principle based on the best corporate governance program. Therefore, future research on corporate governance can investigate the correlation between corporate governance and corporate bankruptcy under the condition of unified region to make the research results more accurate.

References

[1] Avrichir I., Meneses, R., & dos Santos, A. A. (2016). Do family-managed and non-family-managed firms internationalize differently? Journal of Family Business Management, 6(3), 330–349. doi:10.1108/jfbm-02-2015-0014

[2] Baker, C. R., & Hayes, R. (2004). Reflecting form over substance: The case of enron corp. Critical Perspectives on Accounting, 15(6–7), 767–785. https://doi.org/10.1016/j.cpa.2002.08.001

[3] Brisset, N. (2016). Economics is not always performative: Some limits for performativity. Journal of Economic Methodology, 23(2), 160–184. https://doi.org/10.1080/1350178x.2016.1172805

[4] Brown, V. L., Daugherty, B. E., & Persellin, J. S. (2014). Satyam fraud: A case study of India's Enron. Issues in Accounting Education, 29(3), 419–442. https://doi.org/10.2308/iace-50735

[5] Cassidy, D. (2003). Maximizing Shareholder Value: The risks to employees, customers and the community. Corporate Governance: The International Journal of Business in Society, 3(2), 32–37. https://doi.org/10.1108/14720700310474046

[6] Dechow, P. M., GE, W., Larson, C. R., & Sloan, R. G. (2011). Predicting material accounting misstatements. Contemporary Accounting Research, 28(1), 17–82. https://doi.org/10.1111/j.1911-3846.2010.01041.x*

[7] Del Missier, F., Mäntylä, T., & Bruin, W. B. (2011). Decision-making competence, executive functioning, and general cognitive abilities. Journal of Behavioral Decision Making, 25(4), 331–351. https://doi.org/10.1002/bdm.731

[8] Eastwood, J., Snook, B., & Luther, K. (2011). What people want from their professionals: Attitudes toward decision-making strategies. Journal of Behavioral Decision Making, 25(5), 458–468. https://doi.org/10.1002/bdm.741

[9] Perols, J. L., & Lougee, B. A. (2011). The relation between Earnings Management and financial statement fraud. Advances in Accounting, 27(1), 39–53. https://doi.org/10.1016/j.adiac.2010.10.004

[10] Randall, T., Netessine, S., & Rudi, N. (2006). An empirical examination of the decision to invest in fulfillment capabilities: A study of internet retailers. Management Science, 52(4), 567–580.

ISSN 2616-5902 Vol. 5, Issue 12: 10-14, DOI: 10.25236/AJBM.2023.051202

https://doi.org/10.1287/mnsc.1050.0493

[11] Shirur, S. (2011). Tunneling vs Agency effect: A case study of Enron and Satyam. Vikalpa: The Journal for Decision Makers, 36(3), 9–20. https://doi.org/10.1177/0256090920110302

[12] Smale, G. G. (2019). Behaviour and change. Prophecy, Behaviour and Change, 52–59. https://doi.org/10.4324/9780429026645-5

[13] Tuckett, David. "Conviction Narrative Theory and Understanding Decision-Making in Economics and Finance." Oxford Scholarship Online, 2018. https:// doi.org/10.1093/ oso/ 9780198820802. 003.0003.

[14] Widhoyoko, S. A. (2017). Fraud in rights and contracts: A review of bankruptcy case of Livent Inc.. based on governance, risk, and compliance (GRC) framework. Binus Business Review, 8(1), 31. https://doi.org/10.21512/bbr.v8i1.1827

[15] Xia, J., Dawley, D. D., Jiang, H., Ma, R., & Boal, K. B. (2015). Resolving a dilemma of signaling bankrupt-firm emergence: A dynamic integrative view. Strategic Management Journal, 37(8), 1754–1764. https://doi.org/10.1002/smj.2406