Topic Overview	
Topic	BAFS Elective Part - Accounting Module – Financial Accounting A06: Ethical Issues in Accounting
Level	S5 / S6
Duration	2 lessons (40 minutes per lesson)

Learning Objectives:

1. To understand the background information of the Enron Case;
2. To conduct reflective thinking on the lessons learnt from the Enron Case;
3. To demonstrate ethical issues in accounting;
4. To understand the classical Corporate Governance (CG) model which consists of the Chief Executive Officer (CEO), Board of Directors (BOD) and Shareholders; and
5. To evaluate the effectiveness of BOD in performing their roles.

Overview of Contents:

Lesson 1 A Case Study: Enron
Lesson 2 Ethical Issues in Accounting and Corporate Governance (CG)

Resources:

- Topic Overview, Teaching Plan and Answers to Student Worksheet
- PowerPoint Presentation
- Student Worksheet

Suggested Activities:

- Case Study
- Group Discussion

Lesson 1	
Theme	A Case Study: Enron
Duration	40 minutes

Expected Learning Outcomes:

Upon completion of this lesson, students will be able to:

1. Describe the background information of the Enron Case; and
2. Tell the lessons learnt from the Enron Case.

Teaching Sequence and Time Allocation:

Activities	Reference	Time Allocation
Part I: Introduction		
✧ Teacher begins the lesson by asking students "Have you ever heard of the Enron Case?"	PPT #1-4	2 minutes
Part II: Content		
✧ **Case Study** ■ Teacher briefs students on the background of Enron.	PPT #5-6	5 minutes
✧ **Activity 1: The Life of Enron** ■ Students form groups of 4-6 students and complete the flow chart in the student worksheet. They are allowed to make reference to the "Enron timeline" and relevant web links (Appendix I). ■ Before providing the suggested answers, teacher invites volunteers to give their suggestions.	PPT #7-9 Student Worksheet pp.1-3	20 minutes
✧ **Activity 2: Discussion** ■ Students are divided into groups of 4-6 students. ■ Students will discuss within their groups and conduct reflective thinking on the lessons learnt from the Enron Case by answering the questions. ■ Students are required to present their answers in the next lesson.	PPT #10-11 Student Worksheet pp.4-5	10 minutes
Part III: Conclusion		
✧ Teacher reviews the key points.	PPT #12-13	3 minutes

Lesson 2	
Theme	Ethical Issues in Accounting and Corporate Governance (CG)
Duration	40 minutes

Expected Learning Outcomes:

Upon completion of this lesson, students will be able to:

1. Describe some ethical issues in accounting;
2. Describe the classical corporate governance (CG) model which consists of CEO, BOD and Shareholders; and
3. Evaluate the effectiveness of board of directors in performing their roles.

Teaching Sequence and Time Allocation:

Activities	Reference	Time Allocation
Part I: Introduction		
✧ Teacher begins lesson by revisiting the Enron case and key points learnt in the last lesson. ✧ Students will present their findings from the discussion conducted in the last lesson.	PPT #14-16	5 minutes
Part II: Content		
✧ Teacher elaborates on ethical issues in accounting, such as manipulation of data, bribery and conflict of interest, etc.	PPT #17-19	7 minutes
✧ **Activity 3: Case Discussion** ■ Students are divided into groups of 4-6.	PPT #20-21	10 minutes
■ Students are required to discuss within their groups and to identify impacts of ethical issues in accounting in terms of manipulation of data, bribery and conflict of interest in the case provided.	Student Worksheet pp.6-7	
■ Students are required to present their answers.		
■ Teacher explains the meaning of Corporate Governance and classical the CG Model.	PPT #22-24	4 minutes
■ Teacher clarifies how the Enron Case provides insights to help strengthen Corporate Governance.	PPT #25	4 minutes
✧ **Activity 4: Discussion** ■ Students are divided into groups of 4-6.	PPT #26-30	6 minutes
■ Students will discuss the common reasons for the	Student Worksheet	

board of directors ineffectiveness. ■ Teacher asks students to present their answers and reviews the key points with them.	pp.8-9	
Part III: Conclusion		
✧ Teacher reviews the key points of Hong Kong Corporate Governance.	PPT #31-34	4 minutes

Extended Section (Optional):

✧ **Some Relevant Hong Kong Cases** ■ Teacher shares some relevant Hong Kong Corporate Governance cases.	PPT #35-40	

Enron: Scandal Timeline Summary

Time	Events
Early 2000 Enron invested in the dot.com boom.	• As one of the first energy companies to trade through the Internet, Enron's share price rose. • It transferred the losses from its books to a partnership, which was funded by Enron.

Late 2000
Enron continued to expand.
	• Enron's share price rose up to $90. Enron's annual report reported global revenues of US$100bn with income increasing 40% in three years.
	• Without the partnership, the real revenue would have dropped substantially.
	• Enron used advanced accounting tools to keep the share price high and its growth by:
	  • making investments; and
	  • transferring debts to the partnership for potential income

Early 2001 Senior management becomes advisor to national energy policy.	• Enron donated $100,000 to President Bush's inaugural committee fund. • In return, the president invited Enron's senior management, Kenneth, to become an advisor for national energy policies. • As expected, the result of an energy policy review was favourable to the energy industry.
August 2001 Senior executives resigned.	• A chief executive resigned and was replaced by Kenneth. • Investors reacted vigorously and sold millions of shares. The share price dropped below $40. • Another executive resigned. Previously, Enron's senior management had disagreements over partnership transactions.
October 2001 Auditors shred documents.	• Enron's auditor, Arthur Andersen, suggested to change the accounting method for the partnership. • A lawyer reminded Arthur Andersen not to retain unnecessary documents. • Arthur Andersen staff began shredding Enron documents.
November 2001 Enron negotiated for a merger	• Enron restated its profits for the past four years. • It inflated its profits by hiding debts in the complicated partnership arrangements.

	• Enron negotiated on a possible taken-over attempt by Dynegy.
December 2001 Enron filed for bankruptcy protection.	• Enron filed for bankruptcy protection and took legal action against Dynegy for withdrawal from the merger. • Its share price dropped from about $95 to below $1.
January 2002 Investigation started.	• The US Justice Department started a criminal investigation into Enron's situation.

February 2002
Investigation report
	• Key points mentioned in the investigation report:
	  • a fundamental default of leadership and management.
	  • a systematic and pervasive attempt by Enron's management to misrepresent the company's financial position.

(Source from : http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/)

Activity 1 – The Life of Enron (Suggested answer)

Year 2000

(1) **Keep high share price** –use sophisticated accounting techniques
(2) **Attract customers** - by offering them a free trading through the Internet
All time high share price – more than US$90
(3) **Keep on growing**
(i) **accounting** – by making investments and shifting debt off the books to the independent partnerships, in return for income that provided a buffer against future losses
(ii) **investor –** buying futures in electricity supplies and passing them on at higher costs
(4) **Remove losses –** Pass the losses legally to an independent partnership

Year 2001

(1) What did Enron do to against the Potential Energy Policy?
Enron donated US$100,000 to incoming President Bush so that there was a review of planned energy policy which was favourable to the energy industry.
(2) **Resign as the CEO in Aug 2001** – Jeff Skilling
Reaction of Investor – Investors were shocked and began to fear Enron's business. They sold millions of shares and drove down the share price.
Became the CEO – Kenneth Lay
(3) **Became a tragic figure** – Clifford Baxter
(4) **(Oct 2001) Name of accounting firm -** Arthur Andersen
Advice giving to Enron - Arthur Anderson told Enron that they had no other choice but to change the the accounting method for its special partnerships.
What did Arthur Anderson do? The company began shedding key documents.
(5) **(Nov 2001) An unusual move -** Restated its profits for the past four years
Implication - It effectively admitted that it had inflated its profits by concealing debt in the complicated partnership arrangements.

Collapsed

(1) **Negotiation – Name -** Enron's rival, Dynegy
(2) **Date of bankruptcy -** 2 December 2001

Justice

(1) An announcement - In Jan 2002, the Justice Department announced criminal investigation proceedings into Arthur Andersen's activities.
(2) Arthur Andersen admitted that employees had disposed of Enron documents.
(3) Conclusion:
(i) There was a fundamental default of Enron's leadership and management.

(ii) Enron's management attempted to misrepresent the company's financial condition.

BAFS Elective Part Accounting Module – Financial Accounting

Topic A06:
Ethical Issues in Accounting

Technology Education Section
Curriculum Development Institute
Education Bureau, HKSARG
April 2009

Introduction

This session aims to help students identify ethical issues involved in accounting activities. Students will also be able to explain and appreciate the significance of accounting information in corporate governance.

Duration

Two 40-minute lessons

Contents

Lesson One
Learning Objectives

- Understand the background of the Enron Case
- Encourage reflective thinking on lessons learnt from the Enron Case

Lesson 1

Teacher begins lesson by introducing the background information on the Enron Case. Teacher allows students to put themselves in the position of top management and accountants in the situations of Enron Case.

Reflective thinking is encouraged.

A Case Study: Enron

- Enron was one of the biggest US energy companies.
- Its problems stemmed from unethical practices by senior management, for example misrepresenting past accounting figures.

Teacher begins the lesson by asking students: “Have you ever heard of Enron Case?” Teachers is suggested to let students visit the website (http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline) before the lesson or to printout the “Enron Timeline” (Student Worksheet Appendix 1) for students to read during the lesson.

A Case Study: Enron Results were…..

- Arthur Anderson, one of the auditing giant, collapsed
- The Sarbanes-Oxley Act was passed
- This scandal raises public attention toward the importance of corporate governance

Teacher introduces the Enron Case by going through these three points:

1.Arthur Andersen, the former auditing giant, collapsed after being found guilty of deliberately destroying evidence relating to its relationship with Enron. The US Congress swiftly passed into law the Sarbanes-Oxley Act.

2.When studying accounting, students should know the Enron Case and the importance of Corporate Governance (CG).

3.Students should also pay particular attention to top management roles at Enron and how the accountants played in the case.

Enron - Background

July 1985	•Enron was born in July 1985 when Houston Natural Gas merged with Omaha-based InterNorth
	•Kenneth Lay, an energy economist, became chairman and chief executive of Enron
	•Lay's ambition for Enron was to go beyond the business of piping gas
	•Lay wanted to see an energy trading revolution and placed Enron at the heart of it
Late 1980's	Energy corporations lobbied Washington to deregulate the industry. Companies including Enron explained that the extra competition would benefit both companies and consumers.

Before starting the activity, teacher explains the background of Enron with students.

Remark:

- Before deregulation, special commissions were set up to monitor the prices charged to consumers.
- After deregulation, market competition theoretically set the prices, but some controls remained.

Enron - Background

Late 1980's	•New suppliers entered the market and competition increased. The price of energy became more volatile in the free market.
	•Enron saw its chance to make money from these fluctuations. It decided to act as a middle man and guarantee stable prices.
2001	•Enron was a multinational corporation employing thousands of employees with an annual turnover of billions of dollars.
2002	•Enron collapsed.

Teacher continues to brief students some background information about Enron.

Apart from this introduction, students are now required to use 5 minutes to study the printout, the "Enron Timeline". Students need to use this printout to finish **Activity 1**.

Activity 1: The Life of Enron

Enron's collapse was primarily due to unethical behavior by its senior management like misrepresenting past accounting figures.

This is an example of unethical accounting issues. This activity will provide a thorough understanding of Enron's situation.

Activity 1 is an introduction of the Enron Case. The flowchart in student worksheet (p.1-3) showing the life of Enron.

Activity 1: The Life of Enron

- Form groups of 4-6 students
- Students are invited to provide the answers.

Students are required to group into five or six to complete the flowchart within 20 minutes. Students can refer to the "Enron Timeline" and related websites for reference. Teacher can find the answers in topic overview. Before providing the suggested answers, teacher can invite volunteer to give their suggestions.

What is the end?

The Enron Case caused the enactment of a new legislation known as the:

Sarbanes Oxley Act.

→ What is it?

The Sarbanes-Oxley Act is a United States federal law enacted on July 30, 2002 in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom.

These scandals, which cost investors billions of dollars when the share prices of the affected companies collapsed, shook public confidence in the nation's securities markets. Named after Senator Paul Sarbanes and Representative Michael G. Oxley, the Act was approved by the United States House of Representatives by a vote of 423-3 and by the United States Senate 99-0. President George W. Bush signed it into law.

Sarbane-Oxley Act is designed to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws. (www.sox-online.com/basics.html)

Activity 2: Discussion

1. Why did Enron Case surface?
2. Who should bear the blame?
3. Should the accountants/ auditors be equally responsible for the Enron Case? If yes, in what aspects?
4. What can we learn from the Enron Case?

Students are required to form groups of 4-6 and take five minutes to discuss the following questions.

Students are required to present their conclusion in the next lesson.

(Start at the end of the lesson 1 and present in lesson 2.)

1. Enron senior management under-supervised the firm's operations.
2. Many stakeholders like auditors, bankers, lawyers etc should also bear the blame.
3. Auditors helped Enron senior management conceal their bad practices like concealing liabilities.
4. Better corporate governance is required with the enforcement of the legal act.

Activity 2: Discussion

5. What kind of precautionary measures do you suggest to prevent a similar case from occurring again?
6. What “Corporate Governance”?
7. How would “Corporate Governance” work for Enron?

Teacher continues to check the answers with students on the discussion questions.

5. Request Board of Directors to closely monitor the acts of senior management (or any other reasonable answers).
6. Corporate Governance (CG) represents a set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered and controlled. CG also includes the relationships among the many stakeholders involved and the goals by which the corporation is governed.
7. There are numerous ways to implement CG in Enron. One example is requiring Enron to set up an audit committee to review the work of external auditors and make sure the financial statements are presented fairly and accurately. Or ask the board of directors to act using the best code of practices of Cadbury Report. (or any other reasonable answers)

Wrap up!

1. Many stakeholders equally shared the blame for Enron situation other than just the Board of Directors and senior management.
2. Accountants/Auditors failed to perform their responsibilities.
3. Other concerns as to the importance of corporate governance will be discussed in next lesson

Teacher wraps up the lesson by highlighting the following points:

1. Reputation of relevant accountants, auditors, investment bankers, financial analysts who came in contact with Enron were deeply affected by the Enron scandal
2. Inappropriate relationships between the client and accounting firm led to the Enron disaster. The US Securities and Exchange Commission (SEC) subsequently enacted constraints concerning the activities of professional services firms and the relationship with clients.
3. In 2002, the US federal government passed the Sarbanes-Oxley Act, intending to restore public confidence in corporate governance. The next lesson will continue to explore the importance of corporate governance (CG).

Wrap up (Con't)!

4. Related ethical issues in accounting included the manipulation of data by management, "intended" bribery, conflict of interests etc.
5. Companies employing good corporate governance practices are less likely to experience these kinds of issues arise again.

Teacher wraps up the lesson by highlighting the following points:

The Enron Case demonstrated ethical issues in accounting: the manipulation of data, bribery and conflict of interests. Further details will be discussed in the next lesson.

End of Lesson 1.

Lesson Two

Ethical Issue in Accounting and Corporate Governance (CG)

Lesson 2

In this lesson, teacher concludes the Enron case by completing the discussion with students. Connection between Enron case with corporate governance will be demonstrated. Ethical issues in accounting will also be discussed.

Learning Objectives

- Demonstrate some ethical issues in accounting
- Understand the classical Corporate Governance (CG) model which consists of Chief Executive Officer (CEO), Board of Directors (BOD) and Shareholders
- Evaluate the effectiveness of BOD in performing their roles

Teacher begins the lesson by telling students that:

1. There are three anchors of power within the CG model – shareholders, board and management; and there is weak link, thin relationships due to a lack of communication, between shareholders and Board of Directors.
2. The scandals such as Enron, Tyco International, Adelphia, and WorldCom and others demonstrate that members sitting on the Board of Directors failed to fulfill their responsibilities.

Activity 2: Presentation – Enron Case

The Case Study: Enron Discussion Questions

Before discussing the content of lesson 2, teacher invites different groups to present their answers for the discussion questions on slide 10-11.

Teacher may refer to hints on slides #10-11 and offer comments.

Ethical issues in accounting - Manipulation of data

Definition:

- The company's books, records, accounts or financial statements have not been maintained reasonably or they inappropriately reflect the Company's transactions and legal requirements.

Examples:

- Recording expenses and revenues only when the company makes a cash payment or receipt.
- Intentionally mischarging expenses record.

The company has to provide accurate, fair, full, understandable and timely records and reports according to acceptable accounting and legal standards.

Ethical issues in accounting - Bribery

Definition:

- The acts of offering money or gifts influence the recipients' behaviour in ways not consistent with the duties of the recipients or in breach of law.

Examples:

- Receiving a 'secret' commission for purchasing material from a certain supplier without the knowledge of the principals.
- Offering gifts to a potential client to obtain a contract.

All the directors, CEO, other management or officers, and their immediate families should not accept gifts from other person or entity who deal with the Company, if the gift is being made in order to influence their actions.

Ethical issues in accounting - Conflict of interest

Definition:

- The interests or benefits of one person or entity conflict with the interests or benefits of the Company.
- The directors, CEO and other senior management or officers have to avoid situations involving actual or potential conflicts of interest.

Examples:

- Working, in any capacity, for a supplier, customer, competitor, or other third party when employed by the Company.
- Obtaining a guarantee or loan because of the position with the Company.

All the directors, CEO and other senior management or officers have an obligation to conduct themselves in an honest and ethical manner and act in the best interests of the Company.

Activity 3: Case Discussion

Background:

- Lucky Ltd. Co. is a Hong Kong listed company.
- Mr. Lee is a director for Lucky Ltd. Co.
- Mr. Lee's wife is a major shareholder of its customer, Rainbow Co.
- While bidding trading contracts, Mr. Lee brought a diamond ring for a sales manager in Lucky Ltd. Co.
- During the year, Lucky Ltd. Co. had $2 million sales. However, the accounting records reflect $2.5 million.

Teacher introduces the background information of Activity 3 to students. Students can also refer to the student worksheet p.6 for details.

To discuss impacts of ethical issues in the case related to:

- Manipulation of data
- Bribery
- Conflict of interest

The objective of this activity is to understand the accounting ethical issues.

1)Students divide into groups of 4-6.

2)Students are required to discuss within their groups and identify the impacts of accounting ethical issues in terms of manipulation of data, bribery and conflict of interest in the case provided with explanation by completing the Worksheet for Activity 3.

3)Students can suggest other issues in the space provided.

4)Students are required to share their answers with the class at the end.

5)Teacher may discuss the answers with students and offer comments. Teacher can make reference to slides #17-19 when discussing answers.

Corporate Governance - Definition

1. The set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled.
2. The relationships among stakeholders and the goals for which the corporation is governed.

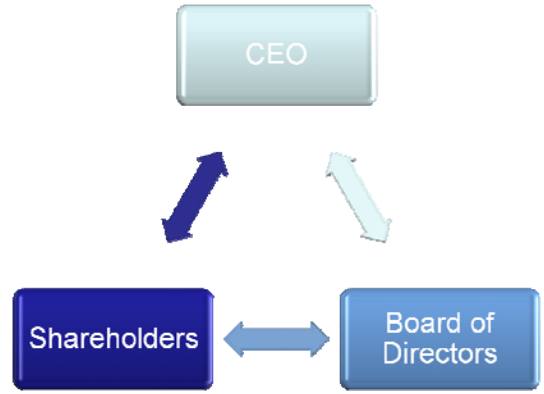
- Teacher introduces corporate governance.
- There has been renewed interest in the corporate governance practices of modern corporations since 2001, particularly due to the high-profile collapses of a number of large U.S. firms such as Enron and Worldcom.
- An important theme of corporate governance is to ensure the accountability of certain individuals in an organisation through mechanisms that reduce the impact of the agency problem.
- Agency problem means that employees like directors (i.e. agent) act unfavourably against the firm (i.e. principal) such as a conflict of interest. For example, managers might be induced to manipulate accounting figures that determine their year-end bonus.

Corporate Governance – Stakeholders

1. The principal stakeholders are the shareholders, management and the board of directors.
2. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

Teacher introduces the principal and other stakeholders of corporate governance (CG).

Classical CG Model



Teacher introduces the CG model to students. Here are the relationships.

(1) Shareholders ←→ Chief Executive Officer (CEO):

-The shareholders provide share capital to the company

-The CEO reports operating results and the state of affairs for the company in annual report

(2) Board of Directors (BOD) ←→ CEO:

-The CEO provides to the Board of directors updated company performance and other matters during board meetings

-The Board of Directors evaluate the CEO's performance

(3) Shareholders ←→ BOD:

The possible weak links:

-Weak control over Board of Directors and performance of their duties

-Lack of information about the performance of the board of directors

-Board of directors have no accountability to shareholders

Enron Case vs Corporate Governance

- ***Drive to strengthen the corporate governance in the world***
- ***Enhance the accountability, integrity and transparency of the financial reports***
- ***Address weaknesses in market foundations and improve market integrity***

Teacher explains how the Enron Case provided insights to strengthen corporate governance.

1. Requires majority of independent directors in listed companies;
2. Tightens the definition of independent director;
3. Empowers non-management directors to check management regularly and management directors not present;
4. Requires corporate governance committee composed entirely of independent directors in listed company;
5. Increases the responsibilities and authority of the audit committee;
6. Discloses the corporate governance guidelines for a listed company;
7. Discloses and adopts a code of business conduct and ethics for directors, officers, employees; and
8. Strengthens the independence of auditors

Here are also some related regulations for strengthening the corporate governance.

- In the USA, the Sarbanes-Oxley Act (SOX) was brought forth in 2002.
- In Hong Kong, Code of Best Practices at Appendix 14 of the Listing Rules established by the Stock Exchange Code --- effective from 1 January 2005.

Activity 4: Board of Directors – Are they performing well?

The objective of this activity is to evaluate the effectiveness of Board of Directors in performing their roles.

- Students are required to form into a group of 4-6.
- Then study the case given in the student Worksheet p.8.
- They will discuss the common reasons for the board of directors ineffectiveness.
- They are required to share their answers with the class.

Activity 4: Ineffectiveness of BOD – Lack of independence (Suggested answer)

Explanations:

- **Employed by the firm**
  - *Some of the members of BOD are employees of the firm and tend to be not forthright.*
- **Provide services to the firm**
  - *BOD is providing services to the firm.*
- **Conflict of interest exists**
  - *BOD has a relationship as an employee of the firm.*
  - *Director's remuneration based on firm performance.*

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Details reasons for the ineffectiveness of BOD for teachers' reference.

- Employed by the firm

When the BOD member is an employee of the firm, he may not report faults caused by him or his co-workers to protect himself, keep his job and maintain a good relationship with his working partners.

- Provide services to the firm

When the member of BOD provides other services to the firm, he may not report the problems related to their services.

- Conflict of interest exists

When the remuneration of a director is connected to firm performance, the director may boost firm profits to increase his remuneration rather than point out the problem.

Activity 4: Ineffectiveness of BOD – Insufficient attention (Suggested answer)

Explanations:

- **Overcommitted**
  - *Some BOD members are outside directors, so they might be overcommitted and cannot give sufficient attention to their role.*
- **CEOs of large corporation**
  - *They might be overcommitted and cannot give sufficient attention to their role.*
- **Come to meeting without any preparation**
- **Insufficient time for the meeting**
  - *The meeting lasts only 10 minutes*

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Teacher may further elaborate the answers as follow:

- Overcommitted

When the BOD member is an outside party, he's not involved in daily management and operations. Usually he acts as a director voluntarily and sometimes he may not have any salary. As the reward is not attractive, he may be unmotivated to invest sufficient time to study firm operations.

- CEOs of large corporation

When the member of BOD is a CEO of a large corporation, he must spend a large amount of time managing his corporation. As a result, he may not adequate time or energy to pay attention to the operation of the firm.

- Come to meetings without any preparation

If a BOD member does not prepare, he may not understand what will be discussed during the meeting and may not offer suggestions for improvement.

- Insufficient time for the meeting

When the meeting lasts for only 10 minutes, the BOD does not have enough time to discuss and make recommendations concerning challenges to the firm.

Activity 4: Ineffectiveness of BOD – Insufficient incentives (Suggested answer)

Explanations:

- **Weak link between firm's performance and directors' pay**
  - *Some of the BOD members feel their efforts are not compensated.*
- **Not enough monetary rewards**
  - *Some of the members of BOD might think they are not well-paid.*

Teacher may further elaborate the answers as follows:

- Weak link between performance of firm and director's pay

The BOD member may not have any interest to address problems and determine possible solutions if he is not compensated for his efforts.

- Not enough monetary rewards

If the BOD member is not rewarded properly, he may not put a lot of effort in helping the firm to improve.

Activity 4: Ineffectiveness of BOD – Avoidance of conflict (Suggested answer)

Explanations:

- **Hard to confront management**
  - *Except when it comes to firing management, it is hard even for independent directors to confront management.*
- **Would like to keep ongoing engagement with top management and *may not point* out problems with management**

Teacher may further elaborate the answers as follows:

- Hard to confront management

If the BOD member points out problems with management, it may be difficult for him to face or co-operate with management in the future unless the person is fired.

- Would like to keep ongoing engagement with top management

If the BOD member is appointed by the management, the management may not renew engagement contacts. To keep their post, directors may not point out management faults.

Corporate Governance in HK

- ***Code of Best Practice of Board of Directors***
- ***Hong Kong Listing Rules has renamed this code as 'Code of Corporate Governance Practices'***

Ask students to pay attention to **CODE OF BEST PRACTICE** (Hong Kong Listing Rules has renamed this code as **Code of Corporate Governance Practices**) from the **Cadbury Report**. The **Cadbury Report**, titled *Financial Aspects of Corporate Governance*, is a report of a committee chaired by Adrian Cadbury that sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The report was published in 1992. The report's recommendations have been adopted in varying degrees by the European Union, the United States, the World Bank, and others.

Wrap up!

- Classical CG model consists of the CEO, Board of Directors and Shareholders.
- Weak links within the CG model between the relationship of BOD and shareholders
- Many ethical issues surface due to the BOD ineffectiveness in executing their duties.
- Code of Corporate Governance Practices of board of directors.

Some guideline like Cadbury Report is issued for people's better understanding and to follow.

Cadbury Report:

A report titled "Financial Aspects of Corporate Governance" was published in 1992. It made recommendations on the arrangement of company board of directors and accounting systems to mitigate corporate governance failures and risks. The report committee was chaired by Adrian Cadbury. The recommendations have been adopted by a lot of countries and cities including Hong Kong.

Code of Corporate Governance Practices in Hong Kong:

- Appendix 14 of Main Board Listing Rules
- Two levels recommendations: 1) Code Provisions; and 2) Recommended Best Practices
- Code Provisions: expected to comply with but may choose to deviate from and devise their own
- Recommended Best Practices: guidance only

Reference

- Relevant websites:
  - Enron Case
    http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/
  - Sarbanes-Oxley Act
    http://www.valuebasedmanagement.net/organizations_sarbanes.html
  - Corporate Governance
    http://www.hkex.com.hk/rule/listrules/Appendix_14.pdf
  - SFC Cases
    http://www.sfc.hk/sfc/html/EN/general/general.html

Teacher introduces references for students to further investigate the case of Enron and corporate governance.

Reference

- Relevant articles:
  - Code of Best Practices
  - Code on Corporate Governance Practices
  - Enforcement Reporter (July 2007 and August 2008)

End of lesson 2.

If time is available, teacher can conduct the extended section to give students more information about Hong Kong cases related to corporate governance.

Teacher should notice that these Hong Kong cases are not required by the curriculum. Teacher can share this information according to students' interest.

Hong Kong Cases

Effect of Enron Case to Hong Kong

- Regulation authorities, companies and stakeholders pay more attention to company **Corporate Governance** which *includes*:
  - Management must work in the best interests of the company
    - ✓ Related Case: *SFC vs Yick Chong San*
  - No insider dealing
    - ✓ Related Case: *SFC vs Hung Lai Mei*

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This is an extended section.

Slides #38-42 provides two Hong Kong cases for students to learn more about how Enron impacted Hong Kong.

Teacher can go through these slides with students according to their interest.

Management must work in the best interest of the company

Case 1: *SFC vs Yick Chong San*

- Background:
  - Director, Yick Chong San, pledged $10M of company funds to secure loans granted to third parties.
  - Parties defaulted and Company sustained a substantial loss of approximately 20% of shareholders' funds.
- Statement:
  - Director pledged the company property to the third parties which is **NOT** in the best interests of the company

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Background:

•Director Misconduct (Case: *Securities and Futures Commission v Yick Chong San [2007])*

•The SFC was against malfeasance or misconduct of a former listed company director, Yick Chong San.

Key facts:

•The director, Yick Chong San, made a decision for securing a loan for third parties by pledging Company funds amounting to $10 million.

•The company was required to repay the lender because the third parties defaulted on the obligation.

•As a result, a material loss amounted to approximately 20% of funds affecting shareholders.

•Not only did the director cause the loss but he did not act in the best interests of the company.

- Court held that:
  - Yick Chong San was disqualified to be appointed or act as a director or involved in the management of a listed company or any subsidiary or affiliate for four years.
- Highlight of the Corporate Governance:
  - Director's duty is to ensure that the company conducts its affairs **properly** and decisions are made in the **best interests** of the company.
  - Director may be **guilty** of misconduct or malfeasance if they breach corporate governance guidelines laid down by the Listing Rules.
  - Directors could be **disqualified** as directors or management of all companies.

The four-year period for the disqualification was set by the High Court due to the serious nature of the allegations and the need for prevention.

The length of the disqualification period can be longer if the defendant does not cooperate.

No insider dealing

Case 2: *SFC vs Hung Lai Mei*

- Background:
  - Hung Lai Mei, finance manager of a subsidiary company, sold her shares of the holding company before the market realised that the holding company major debtor became bankrupt;
  - When the debtor's bankruptcy news was announced, the holding company share price dropped 23%;
  - Hung avoided a loss of $63K because of her early disposal of shares.

Background:

•First Criminal Conviction for Insider Dealing (Case: *Securities and Futures Commission v Hung Lai Mei [2008])*

•The SFC was against insider dealing of a finance manager of a limited company, Hung Lai Mei.

Key facts:

•In October 2004, Hung Lai Mei was aware a major debtor of Sino Golf Holdings Limited, Huffy Corporation, which could not pay its debt to Sino Golf Holdings Limited.

•The reason is because the debtor filed for bankruptcy protection in the USA. The debtor owed Sino Golf Holdings Limited $11.9 million. She knew Sino Golf Holdings Limited needed to make provision for accounts receivables. As a result, the financial position and share price of Sino Golf Holdings Limited was affected.

•In December 2004, before the news was made public, Hung Lai Mei sold all her shares of Sino Golf Holdings Limited. Until 18 April 2005, Sino Golf Holdings Limited announced its financial results, the public realised $9.5 million bad debt incurred and net profit dropped by 35%.

•On 19 April 2005, the share price of Sino Golf Holdings Limited decreased by 23% due to the negative news. For the early disposal of Sino Golf Holdings Limited shares, Hung Lai Mei avoided an estimated loss of $63,333.

- Statement:
  - Finance manager conducted **insider dealing** because she sold shares before the information was disclosed to the public.
- Court held that:
  - Insider dealing is an offence which can result in imprisonment.
  - Hung Lai Mei was sentenced to six months' imprisonment, suspended for 2 years.
  - Fined $200,000 and paid $20,523 cost to SFC.
- Highlight of the Corporate Governance:
  - Insider dealing is **prohibited.**
  - Insider dealing is a **criminal** offence.

Court held that:

Hung Lai Mai was sentenced to six months imprisonment.

The imprisonment was suspended for two years. In addition, she was ordered to pay $20,523 in costs to the SFC and fined $200,000 ($50,000 on four separate charges).

The imprisonment was suspended because Hung Lai Mei entered a plea of guilty for saving her from an immediate custodial sentence. The Court sent a clear message that insider dealing is an offence. It can result in imprisonment.

The End

Teacher highlights the points covered in the lesson.

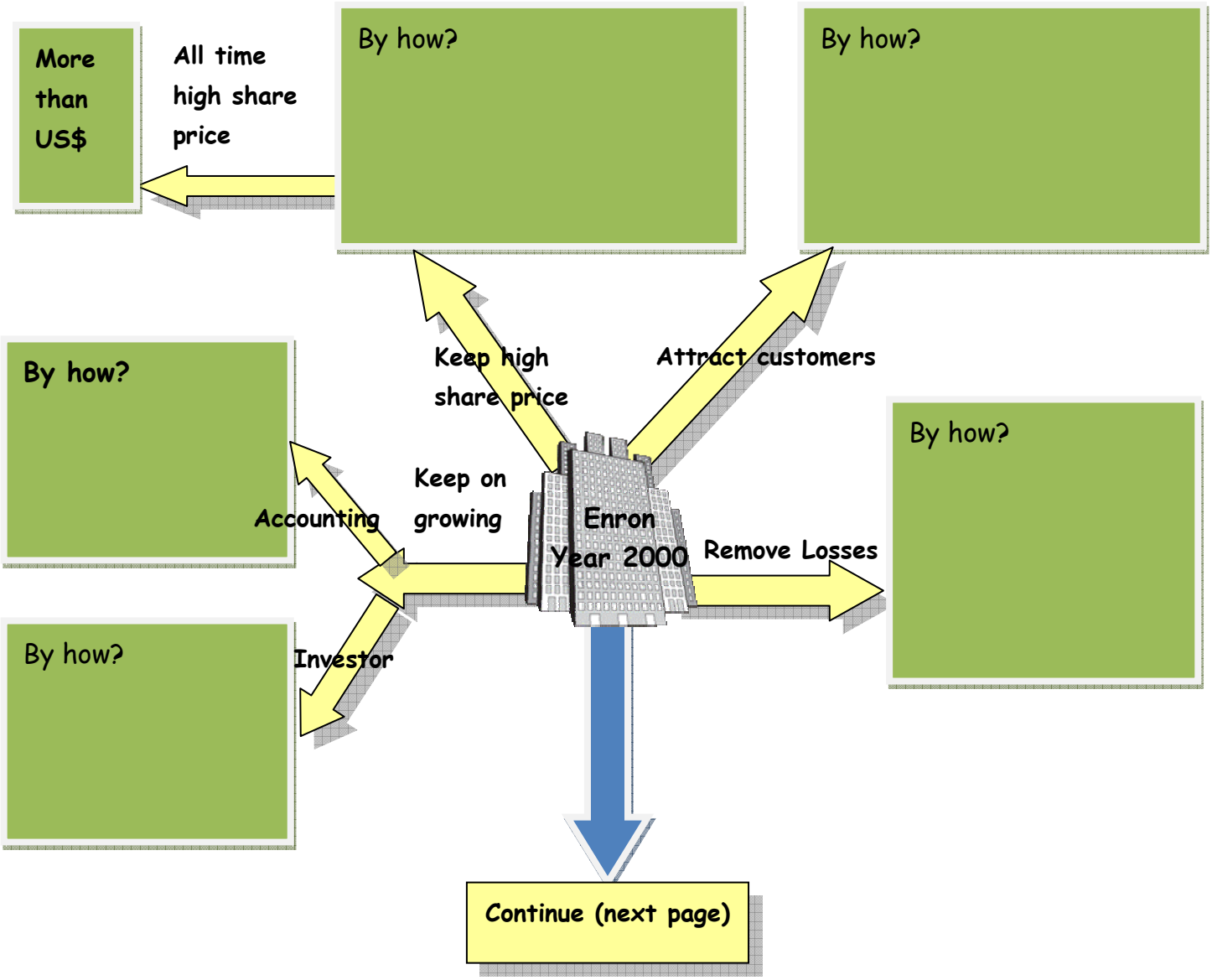
End of Lesson 2 (Extended Section).

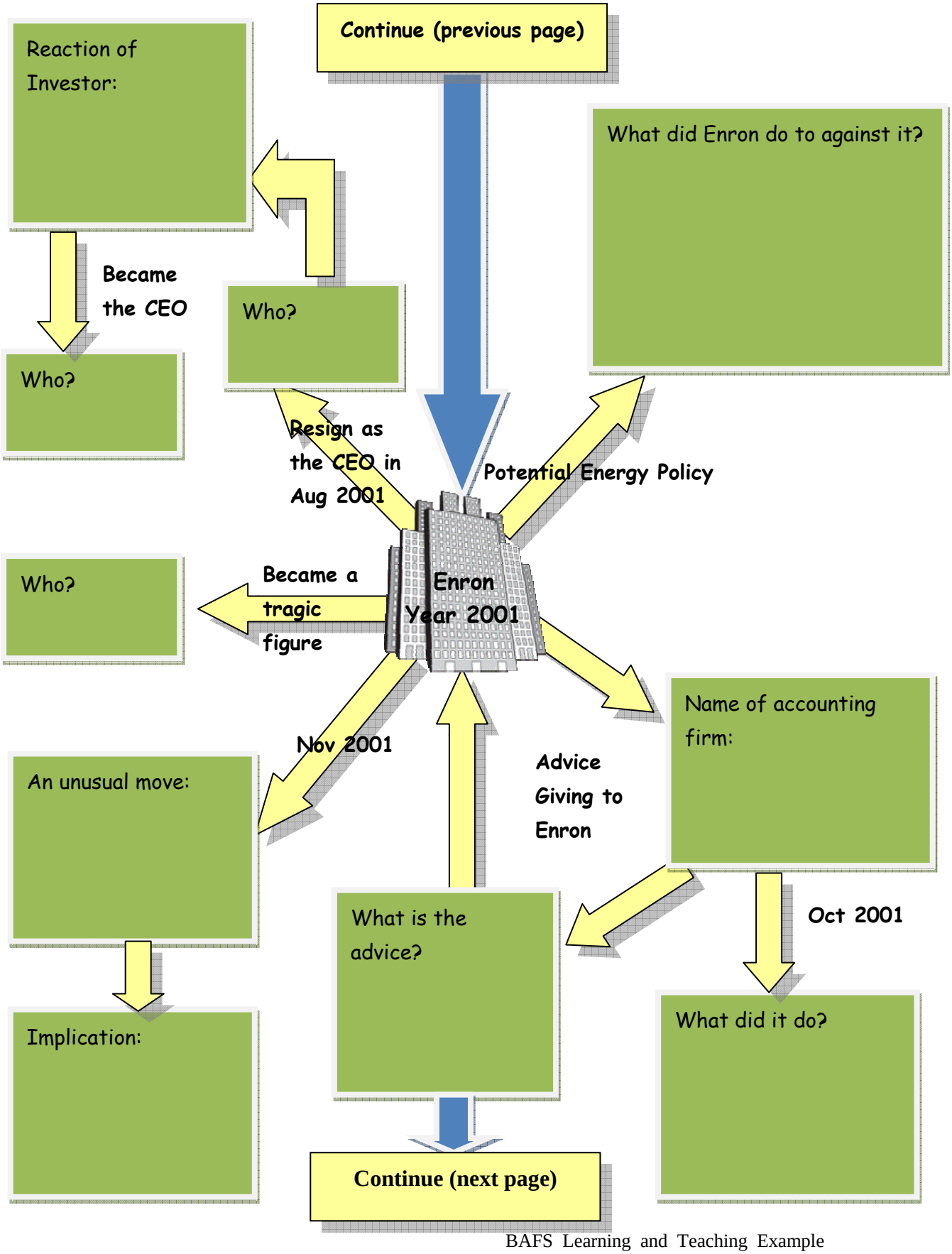
BAFS Elective Part - Accounting Module – Financial Accounting
Topic A06: Ethical Issues in Accounting

The Case Study: Enron

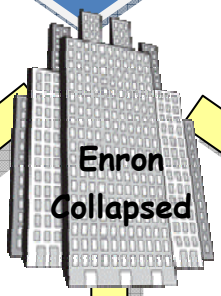
Activity 1 – The Life of Enron

Students are required to complete the flow chart with reference to the "Enron time-line" and relevant web link given to you in Appendix 1.




Continue (previous page)
Reaction of Investor:
What did Enron do to against it?
Became the CEO
Who?
Who?
Resign as the CEO in Aug 2001
Potential Energy Policy
Enron Year 2001
Who?
Became a tragic figure
Name of accounting firm:
Nov 2001
An unusual move:
Advice Giving to Enron
What is the advice?
Oct 2001
Implication:
What did it do?
Continue (next page)

Cont'd (previous page)



Enron Collapsed

Negotiation

Name:

Bankruptcy

Date:

(Filed protection in a New York court)

Performance of share

<u>An announcement</u>

In Jan 2002,

<u>Conclusion:</u>

1)

2)

Justice

Arthur Andersen admitted

Pass

Sarbanes-Oxley Act

Activity 2 – Discussion

After finishing the Activity 1, students are requested to do the following reflections:

1. Why did the Enron Case surface?

2. Who should bear the blame?

3. Should the accountants/ auditors be responsible for the Enron Case? If yes, in what aspects?

4. What can we learn from the Enron Case?

5. What kind of precautionary measures do you suggest to prevent a similar event happening again?

6. What is corporate governance?

7. How would "Corporate Governance" work for Enron?

Activity 3 – Discussion

What kind of ethical problems in accounting have been surfacing?

Background information

- Lucky Ltd. Co. is a Hong Kong listed company.
- Mr. Lee is a director for Lucky Ltd. Co.
- Mr. Lee's wife is a major shareholder of its customer, Rainbow Co.
- For bidding trading contracts, Mr. Lee brought a diamond ring for a sales manager in Lucky Ltd. Co.
- During the year, Lucky Ltd. Co. had $2 million sales transactions. However, in the accounting record, the amount was $2.5 million.

These types of ethical problems in accounting (like manipulation of data, bribery and conflict of interest) are shown in the first column. Please provide the explanations in the second column. You may also suggest some other ethical problems in the space provided.

Ethical issues	Explanations
1. Manipulation of data	
2. Bribery	

3. Conflict of interest	
4.	
5.	

Activity 4 – Discussion

Are the Board of Directors performing their roles?

Read the following short article and fill in the following table:

The Wisa board meeting, a US listed credit card company, was going to be held in 10 minutes. This kind of board meeting is held twice per year.

During the board meeting, both Mr. Andersen and Mr. Ball fell asleep ……

Mr. Adrian Andersen:

- CEO of another US listed technology company IBN.
- He came to the meeting in hurry.
- He finished an urgent IBN meeting that morning.
- He is employed as an outside director with Wisa for more than 5 years.
- His main duty is a physical presence at the Wisa board meeting.
- He openly confesses he never had time to "digest" any relevant documents before a board meeting

Mr. Boris Ball

- Non-executive director of Wisa since its launch.
- He had close private business with Wisa.
- He owns a consultancy firm which focuses on customer credit analysis and frequently provides consultancy services to Wisa.
- His remuneration for the post of Wisa is nominally low and fixed whatever how good Wisa is operated.

Common reasons for the ineffectiveness (like lack of independence, insufficient attention etc.) of the board of directors are provided in the first column. Please give explanations in the second column by complete the following table.

Common reasons of ineffectiveness of board of directors	**Explanations**
1. Lack of independence	✓ Employed by the company
2. Insufficient attention	
3. Insufficient incentive	
4. Avoidance of conflict	

Appendix 1

Enron: Scandal Timeline Summary

Time	Events
Early 2000 Enron invested in the dot.com boom.	• As one of the first energy companies to trade through the Internet, Enron's share price rose. • It transferred the losses from its books to a partnership, which was funded by Enron.

Late 2000
Enron continued to expand.
	• Enron's share price rose up to $90. Enron's annual report reported global revenues of US$100bn with income increasing 40% in three years.
	• Without the partnership, the real revenue would have dropped substantially.
	• Enron used advanced accounting tools to keep the share price high and its growth by:
	  • making investments; and
	  • transferring debts to the partnership for potential income

Early 2001 Senior management becomes advisor to national energy policy.	• Enron donated $100,000 to President Bush's inaugural committee fund. • In return, the president invited Enron's senior management, Kenneth, to become an advisor for national energy policies. • As expected, the result of an energy policy review was favourable to the energy industry.
August 2001 Senior executives resigned.	• A chief executive resigned and was replaced by Kenneth. • Investors reacted vigorously and sold millions of shares. The share price dropped below $40. • Another executive resigned. Previously, Enron's senior management had disagreements over partnership transactions.
October 2001 Auditors shred	• Enron's auditor, Arthur Andersen, suggested to change the accounting

documents.	method for the partnership. • A lawyer reminded Arthur Andersen not to retain unnecessary documents. • Arthur Andersen staff began shredding Enron documents.
November 2001 Enron negotiated for a merger	• Enron restated its profits for the past four years. • It inflated its profits by hiding debts in the complicated partnership arrangements. • Enron negotiated on a possible taken-over attempt by Dynegy.
December 2001 Enron filed for bankruptcy protection.	• Enron filed for bankruptcy protection and took legal action against Dynegy for withdrawal from the merger. • Its share price dropped from about $95 to below $1.
January 2002 Investigation started.	• The US Justice Department started a criminal investigation into Enron's situation.

February 2002
Investigation report
	• Key points mentioned in the investigation report:
	  • a fundamental default of leadership and management.
	  • a systematic and pervasive attempt by Enron's management to misrepresent the company's financial position.

(adapted from : http://news.bbc.co.uk/hi/english/static/in_depth/business/2002/enron/timeline/)