

# LONDON OR NEW YORK? IMPLICATIONS OF THE ENRON DEBACLE FOR LAW AND ACCOUNTING REFORM IN HONG KONG



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*The collapse of the American corporation Enron has profound and hard lessons for Hong Kong. Enron has provided new examples of ways in which it is possible for unethical business behaviour to be lawful, in the positivist sense of law. This article argues that the complex relationship between the Companies Ordinance and the protection of investors can never be stated as more than a set of principles. The superstructure of the “public interest” rests, somewhat uneasily, on the professional shoulders of accountants. Accounting standards fill the gap between law and ethics in the system. The meaning of what is understood by a “true and fair view” remains the same, whilst the “contents” (ie specific accounting regulations) can be expected to change. A question for Hong Kong is who decides, and who should have the final say on those “contents”: the accounting profession, the stock exchange, an accounting standard setter, the Securities and Futures Commission, or the Government?*

## Introduction

Enron, the company with the seventh highest revenues in the USA, filed for bankruptcy on 2 December 2001<sup>1</sup> becoming the largest bankruptcy in American history. Many of the facts relating to the rise and fall of Enron are difficult to ascertain, particularly the reasons for the sudden collapse of the Enron share price in October and November 2001. Enron had created a large number of Special Purpose Entities (SPEs) which held investments, but these SPEs were not consolidated in the balance sheet of Enron, although their existence and purpose were partially disclosed in the notes to Enron’s financial statements. The initial media attention after the bankruptcy was directed

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<sup>1</sup> The first indictment arising out of the Enron bankruptcy happened in Mar 2002 – an indictment of Andersen, the auditors of Enron, for obstruction of justice. A copy of the indictment is available at <http://www.c-span.org/enron/andersen.pdf>. Further charges were expected. Several of the senior executives of Enron who were asked to testify in Congressional hearings took the protection of the Fifth Amendment to the United States Constitution which allowed them to decline the invitation to answer questions under oath.

to allegations of concealing “off-balance-sheet” finance. Later it was discovered that the most controversial SPE was Raptor. Raptor had a different purpose from other SPEs. It was a vehicle used to underwrite the value of Enron’s investments. It was the failure of Raptor to achieve the purpose for which it was created and an associated accounting adjustment which caused Enron to announce the write-down of its assets and equity by US\$2 billion in October 2001.<sup>2</sup> The write-down triggered a collapse of confidence which led to the failure of a merger in November and the bankruptcy in December.

Raptor had been discussed in an internal memo that an Enron Vice-President, Sherron Watkins, had written in August 2001 to the chairman of Enron, Mr Kenneth Lay.<sup>3</sup> In this memo Ms Watkins said:

“I am incredibly nervous that we will implode in a wave of accounting scandals. My eight years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax.”<sup>4</sup>

The prescience of Ms Watkins’ memo and the clarity of her exposition of the nature of the Raptor dealings with Enron made her a heroine of both those who lost their jobs at Enron and of those investors, including employees and pensioners, who lost a great deal of money in the rapid collapse of the Enron share price in the weeks leading up to the bankruptcy.<sup>5</sup> Ms Watkins’ behaviour in trying to avert the impending disaster contrasted markedly with the self-serving behaviour of some of the senior executives who had made large capital gains by selling their stock in the period preceding the collapse.

It is not our purpose in this article to provide an exposition of the issues raised for the American body politic by the collapse of this corporation. Those issues include energy policy, campaign finance reform, pension protection, auditor independence and directors’ duties. Our purpose is to draw lessons for accounting regulation in Hong Kong from the Congressional hearings arising from the bankruptcy. The hearings were marked by an almost desperate attempt by US politicians to find culprits to shoulder the blame for the collapse, combined with difficulties in establishing exactly which laws had been broken and which accounting standards had failed.

<sup>2</sup> The write-down of equity and assets and a restatement of earnings for earlier years is documented in the Enron SEC 8K filing dated 8 Nov 2001 on the SEC website at <http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/0000950129-01-503835.txt>.

<sup>3</sup> This memo is available as part of the documentation for a Congressional hearing by the US House Energy and Commerce Committee at <http://energycommerce.house.gov/107/hearings/02072002Hearing485/tab17.pdf>.

<sup>4</sup> *Ibid.*

<sup>5</sup> Enron had a stock market valuation of approximately US\$100 billion in Jan 2001. By the end of the year, this value had evaporated completely and there were insufficient funds in the company to settle the liabilities to creditors.

One way of looking at the collapse of Enron for Hong Kong regulators is to identify the fundamental differences for Hong Kong in choosing either the New York or London model of accounting standards in terms of the coherence in the value system protected in each regime.<sup>6</sup> The business of standard setting is now left to the experts and represents an intersection of professionalism where law meets ethics. It goes to the heart of the Enron debate. Can and should unethical behaviour go unpunished? Would it not obviously be desirable to have a law to prevent all types of questionable accounting practice? The value system underlying these questions contains the very paradox that faces the regulators responsible for reform of Hong Kong company law, reform of corporate governance, and reform in the securities industry. We therefore argue that, contrary to all expectations and popular conceptions of the role of law in the protection of the “public interest”, the accountants must be allowed to have the final say in the question of standard setting. The profound lesson emerging from the fall of Enron is that accounting standards fill the gap between law and ethics for the auditors, for questions of governance, and for the protection of the “public interest” – whatever that may be.

We start, therefore, with a consideration of Sherron Watkins’ testimony on Enron’s use of Raptor to hedge its investments. We conclude that her arguments are founded more in ethics than in law. The following section summarises the Hong Kong approach to accounting standards and compares the Hong Kong approach to that in the USA and the United Kingdom. Other congressional testimony is then discussed which has highlighted the difficulty of creating effective accounting regulation using a multitude of narrow rules in the American style rather than a smaller number of broad principles in the British style. The final section deals with the implications of these discussions for the future development of accounting regulation in Hong Kong.

### **Sherron Watkins’ Testimony**

The following excerpt is from the testimony of Sherron Watkins to a US congressional sub-committee on 14 February 2002. Watkins’ statement on her understanding of Enron’s accounting practices with the special purpose entity Raptor, described below, poses a fundamentally important question for Hong Kong company law and accounting standards and contains a hard lesson for Hong Kong regulators.

<sup>6</sup> We use the terms New York and London to typify the American and the British approaches to accounting regulation because these cities are the models usually held up as examples for Hong Kong to emulate in its evolution towards “World City” status, and because they are the locations of the main US and UK stock markets.

“While working for Mr Fastow in 2001, I was charged with reviewing all the assets that Enron considered for sale and determining the likely economic impact of a sale. As part of the sale analysis I reviewed the estimated book values and market values of each asset.

A number of assets were hedged with an entity called Raptor. Any asset that was hedged should, for the most part, have a locked in sales value for Enron. Meaning that despite current market prices, Enron should realise the hedged price with Raptor.

It was my understanding that the Raptor special purposes entities were owned by LJM, the partnership run by Mr Fastow.

In completing my work, certain Enron business units provided me with analyses that showed certain hedged losses incurred by Raptor were actually coming back to Enron. The general explanation was that the Enron stock backstopping the Raptor hedge had declined in value such that Raptor would have a shortfall and would be unable to cover the hedged price it owed to Enron.

I was highly alarmed at the information I was receiving. My understanding as an accountant is that a company should never use its own stock to generate an income gain or avoid a loss on its income statement. I continued to ask questions and seek answers primarily from former co-workers in the global finance group or in the business units that had hedged assets with Raptor. I never heard reassuring explanations ...”

“My understanding was that the Raptor entities basically had no other business aside from these hedges; therefore they had collectively lost over US\$700 million. I urged Mr Lay to find out who had lost that money. If he discovered that this loss would be borne by Enron shareholders via an issuance of stock in the future, then I thought we had a large problem on our hands.”<sup>7</sup>

Sherron Watkins pointed out that by the time she told Chairman Kenneth Lay of the accounting problems that she predicted faced Enron, Raptor owed Enron in excess of US\$700 million. Raptor was one of many special purpose entities (SPEs) created by Mr Andrew Fastow, the Chief Financial Officer of Enron, a practice that had earned him both praise from the CFO

<sup>7</sup> Sherron Watkins, “Opening Statement”, 14 Feb 2002, Oversight and Investigations Subcommittee of the House Energy and Commerce Committee of the United States House of Representatives <http://energycommerce.house.gov/107/hearings/02142002Hearing489/Watkins801.htm>.

*Magazine*,<sup>8-9</sup> and also the vilification of the media as the chief suspect in the search for the explanations for the Enron “tragedy” after the bankruptcy of the company in December 2001.<sup>10</sup>

### The Role of Law and Ethics in the Protection of Investors

The hearing at which Sherron Watkins was testifying was entitled “Financial Collapse of Enron Corp”. At the same time as this certified public accountant was giving her clear explanation on the uses and misuses of SPEs and off-balance sheet accounting practices, there was also taking place another hearing by the Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection entitled “Are Current Financial Accounting Standards Protecting Investors?” The US Senate Banking Committee was simultaneously conducting a hearing entitled “Accounting and Investor Protection Issues Raised by Enron and Other Public Companies”.

The hearings identified above on 14 February 2002 are just three of many Enron-related hearings held in Washington since December 2001.<sup>11</sup> The hearings can be divided broadly into two groups: one group is investigating what happened, how it happened, and who bears most responsibility for the misfortunes that befell employees and investors in the company; and the other group is evaluating the reforms needed to prevent similar disasters ever happening again. The hearings are raising many concerns for the legal and accounting professions in the USA, but the problems being identified and the reforms being discussed are also clearly relevant in Hong Kong. Some of the issues debated in Washington, we shall argue, have not been adequately addressed by corporate governance reform as it has so far been conducted within the SAR.

One key component of the hearings is the importance of ethics – the professional ethics of lawyers and accountants; the ethics of directors and managers; the ethics of the market place; and the ethics of society. Within the debates about ethics, questions of independence and conflict of interest are central. Several US congressmen and women have commented in these hearings that what they find particularly shocking about the revelations is

<sup>8-9</sup> “Fastow at center of Enron storm / Aggressive and driven, ex-CFO has many faces”, *Houston Chronicle Sunday*, 20 Jan 2002, p 1, Section A. By 1999, Fastow’s activities had captured the attention of *CFO Magazine*, which awarded him its CFO Excellence Award for Capital Structure.

<sup>10</sup> At another congressional hearing Mr Andrew Fastow did not testify after taking the protection of the Fifth Amendment to the United States Constitution. See “The Fall of Enron / Taking the Fifth”, *Houston Chronicle*, 8 Feb 2002, p 19, Section A.

<sup>11</sup> These Congressional Hearings are typically available on the relevant Congressional Committee website for viewing via the Internet, either simultaneously or subsequently. Witness testimony and the opening statements by members of the committee are similarly available on the date of the hearing and the full transcript of the hearing is typically made available during the subsequent two months.

not the things that were done which are illegal, but that much of what was done was within the law and sanctioned by American “generally accepted accounting principles” (GAAP).

This article asks a question from the Hong Kong law and accounting perspective. Is Sherron Watkins’ fundamental accounting principle that a company can *never* use its own stock to generate a gain or avoid a loss on its income statement “good law” or is it simply an accounting convention that is applied by ethical accountants in an ethical world?

The Watkins statement might be even more properly described as a system of meta-ethics that we have come to rely upon in the complex penumbral world of the Hong Kong Accounting Standards created by the Accounting Standards Committee of the Hong Kong Society of Accountants.<sup>12</sup> These standards have a complex relationship to the Companies’ Ordinance and the protection of the investor. The edifice upon which the standards rest has three elements to its foundation:

- 1 the investors’ reliance on the auditors as the experts with their professionalism and commitment to “the public interest”;
- 2 the criminal law’s definitions of accounting offences involving dishonesty; and
- 3 the development of the auditor’s duty of care in the area of professional negligence.

The problem of identifying and defining questionable “unethical” accounting practices is left for the most part to an assessment of what is and what is not “professional misconduct” in the view of the Disciplinary Tribunal of the Hong Kong Society of Accountants. This is the area between law and accounting standards that we describe as the meta-ethics or the superstructure integrating the relationship between auditor, the Companies Ordinance and the investor. Such a superstructure relies, ultimately, on the accountants as a professional body being able and willing to identify at any given time what is meant by the “public interest”. The collapse of Enron may in fact force Hong Kong regulators to define what the accountants mean by “public interest” if the relationship between law and accounting standards is to continue to provide a suitable superstructure to hold the system together.

#### *Is the Sherron Watkins Principle “Good Law”?*

The lawyers and accountants in Hong Kong ask themselves if Watkins’ statement is “good law”, that is to say is it authoritative law (without any reference to its ethical content) as a matter of professional training. It is, as it were,

<sup>12</sup> The Accounting Standards Committee of the Hong Kong Society of Accountants was created in 1982.

a reflex reaction to the events revealed in the Enron hearings. Lawyers and accountants trained in the Hong Kong common law system and familiar with professional accounting standards would attempt to answer the question whether Watkins' statement represents the law in Hong Kong in the following three ways.<sup>13</sup> First, lawyers would attempt to identify a relevant statutory principle clearly defined within the Companies Ordinance.<sup>14</sup> Since it is not possible to see it clearly articulated as a principle of company law in the Companies Ordinance,<sup>15</sup> lawyers would then, as a second attempt, seek to find it in the Hong Kong common law system implicating and including the auditors in either the area of criminal law typically associated with the duties of company directors to the company or in the breach of the auditors' contractual duties or in negligence to third parties. The relevant criminal "behaviour" is defined in the relevant criminal law sections in the Companies Ordinance. These sections penalise the production of false and misleading accounts using unacceptable accounting practices. Such criminal offences involve a deliberate attempt to mislead shareholders and third parties and must be described as criminal offences involving dishonesty. They do not, however, properly describe the questionable and unethical accounting practices that this article argues are in fact represented by the Watkins statement. In addition to criminal offences, there are also developments in the law of negligence, particularly in relation to the protection of investors in the post-*Caparo*<sup>16</sup> era

<sup>13</sup> We fully recognise that the law relating to corporate and securities law in Hong Kong can be found in three distinct areas. The first is the common law decisional case law. The second is in the detail of the statutes themselves, ie The Companies Ordinance (Cap 32), The Securities Ordinance (Cap 333), The Protection of Investors Ordinance (Cap 335), The Commodities Trading Ordinance (Cap 250), The Securities (Disclosure of Interests) Ordinance (Cap 396), and The Securities (Insider Dealing) Ordinance (Cap 395). The third is found in the non-legal norms, ie The Listing Rules; The Hong Kong Codes on Takeovers and Mergers and Share Repurchases; The Code on Unit Trusts and Mutual Funds; the Code on Investment-Linked Assurance Schemes and Saving Plans; The Code on Pooled Retirement Funds; and The Code on Immigration-Linked Investment Schemes. There is also a fourth, less highly developed, area for the protection of investors and the jurisprudence of Hong Kong corporate governance. This is the development of a body of administrative decisions by the Securities and Futures Commission (SFC). This will become more important after Hong Kong's modern facelift created by the introduction of The Securities and Futures Commission Ordinance as new law in 2002 after a long legislative gestation period. None of these distinct areas of legal and non-legal norms solves the problem identified by Sherron Watkins, that is pursued in this article. It is, in fact, impossible for accountants and lawyers in Hong Kong to confirm that the Watkins' statement either does or does not represent "good accounting" or "good law".

<sup>14</sup> Cap 32.

<sup>15</sup> Nor is the answer to be found stated as a statutory principle in any of the three areas of corporate and securities laws listed in n 13 above.

<sup>16</sup> *Caparo Industries plc (CI) v Dickman* [1990] AC 605. The situation becomes even more complex in the case of groups of companies. The English case *Coulthard v Neville Russell (a firm)* [1998] 1 BCLC 143 highlights the point beautifully for the present argument on the expertise of auditors and on how difficult it is to find the law backing up Sherron Watkins' statement. On the facts of *Coulthard*, the auditors failed to advise the directors on the problems of a subsidiary borrowing money from the parent company to buy the subsidiary's own shares and thus provide financial assistance in breach of the English equivalent of s 47A. The facts of Enron are arguably not dissimilar in terms of law and accounting principles.

and the search for what public policy regards as the socially and economically appropriate limit on the auditors' liability to an indeterminate group for an indeterminate time for an indeterminate amount. In none of these areas of the law, however, do we find the answer to the question raised by Sherron Watkins' statement as to whether as a matter of law and accounting it is possible for a company to use its own stock to generate an income gain or avoid a loss on its income statement. Since we cannot find the answer to the question in the Companies Ordinance, nor in the case law on auditors' liability, we must take a third approach and investigate whether it lies in the superstructure of the integrated relationship between law, accounting and professional standards imposed by the Hong Kong Society of Accountants.

### *The Integrated Relationship of Law and Accounting Standards*

Looking for the answer in the relationship of law and accounting standards rests, finally, on a positivist view of the relationship between law and accounting in Hong Kong. This answer would suggest that Watkins' statement represents a conventional accounting practice that falls under a generally accepted accounting principle. As such, it falls outside the strict definition of law, but as used in certain conventional ways by the experts it has become quasi-legal within the spirit, if not the letter, of the law. If it is not, in fact, a legal rule, the experts, the professional accountants, must be seen not only to understand the principle, but also to use it with certainty and predictability as the professionals upon whom the role of trusted advisor and custodian of financial ethics is placed.<sup>17</sup> The problem therefore becomes one of identifying the relationship of accounting standards to law,<sup>18</sup> and whether the existing Hong Kong balance is appropriate. The Watkins statement of law and accounting also highlights the limitations of a positivist lawyer's view of

<sup>17</sup> For a detailed description of the Hong Kong Auditing Guidelines setting out the Statements of Auditing Standards in Hong Kong, see Ferdinand Gul, *Hong Kong Auditing Economic Theory and Practice* (Hong Kong: City University of Hong Kong Press, 2000), pp 683–769 where Professor Gul sets them out for accounting students. Once again, it is impossible to find the answer to as to whether the Watkins statement represents good accounting practice for Hong Kong.

<sup>18</sup> Hong Kong auditors face common law liability for breach of contract, breach of fiduciary duty and negligence. They also face disciplinary proceedings from the Hong Kong Society of Accountants for professional misconduct, investigation by the SFC, and are subject to the law and self-disciplinary regulation as set out in The Professional Accountants Ordinance (Cap 50). See, for example, *BDO Binder & Others v Hong Kong Society of Accountants* [2000] HKEC 962. In the Court of First Instance Constitutional and Administrative Law List Action No 15 of 2000, three firms of accountants under investigation pursuant to s 42C of the Professional Accountants Ordinance sought to quash the decision of the Hong Kong Society of Accountants to set up a committee to discourage dishonourable conduct and to investigate the failure to maintain or apply a professional standard. See also Stock J's analysis of the role of the Hong Kong Society of Accountants in *Ernst & Young (A Firm) v Hong Kong Society of Accountants (A Body Corporate)* [2000] HKEC 283. Stock J sets out the provisions of s 34, the background to the amendments to the Ordinance in 1994, and the difficulties in statutory interpretation and policy making for the professional body concerned, in terms of access, accountability and client confidentiality.



accounting principles which by definition check on whether a company has acted systematically and not on the quality of the content of a company's actions. In other words, why is it so difficult to answer the question? The answer, it would seem, is because it is not law at all, but a statement of a fundamental accounting principle that we expect only the experts to understand. The question then becomes, if it is not in fact a part of any generally accepted legal principle in Hong Kong, is it good accounting?

*Does the Watkins Statement Represent "Good Accounting"?*

As stated by Watkins, the central relationship at issue is between the shareholders and the directors. Shareholders have entrusted resources to the directors and the directors are expected to "maximise shareholder value".<sup>19</sup> This is done by increasing the value of the assets owned by the company, which if done effectively and disclosed appropriately will be reflected in the value of the shares and thus in the wealth of the shareholders.

This relatively simple definition of the relationship can be eroded in a number of ways when the capital resources of the company are reduced by decisions of the directors. The British and American legal systems seem to have had different interpretations of the problems involved.

- 1 Can a company (corporation) buy its own shares and sell them again?  
Yes in America.<sup>20</sup> No in the United Kingdom.<sup>21</sup> No in Hong Kong.<sup>22</sup>
- 2 Can a company (corporation) return capital to the shareholders?  
Yes in America.<sup>23</sup> No in the United Kingdom.<sup>24</sup> No in Hong Kong.<sup>25</sup>

<sup>19</sup> For an extended discussion of the objectives of business and the ethics involved, see Elaine Sternberg, *Just Business, Business Ethics in Action* (Oxford: Oxford University Press, 2nd edn, 2000).

<sup>20</sup> The practice of buying and re-issuing treasury stock (ie a corporation trading in its own shares) is common in the United States.

<sup>21</sup> See John Farrar, *Company Law* (London: Butterworths, 2nd edn, 1998), p 146. Since *Trevor v Whitworth* (1887) 12 App Cas 409 it has been "unlawful" for a company to purchase its own shares as part of the clearly articulated rules for capital maintenance under English company law, but note the relaxation of the capital maintenance rules for private companies, closely followed by Hong Kong. For an excellent analysis of the capital maintenance principle and the rule in *Trevor v Whitworth*, see Philip Smart et al, *Hong Kong Company Law Cases, Materials and Comments* (Hong Kong: Butterworths Asia, 1997).

<sup>22</sup> See s 47A, s 47B, s 47C and the relaxation of this rule under s 47E of the Companies' Ordinance.

<sup>23</sup> Although each state in the US has its own company law statute, making it difficult to generalise broadly about American company law, the concept of the "liquidating dividend", which involves the reduction of capital, is widely discussed as acceptable practice in US accounting literature. The lack of a clearly defined share premium account and the practice of issuing no-par value shares result in a less well-defined concept of capital maintenance generally in the US. The variety of restrictions on dividends described in Kenneth W. Clarkson et al, *West's Business Law* (Cincinnati: West Legal Studies in Business, 8th edn, 2001), at p 671 makes it clear than in some states there is no statutory restriction on distributing a capital surplus.

<sup>24</sup> See John Farrar, *Company Law* (London: Butterworths, 4th edn, 1998), p 169. The basic principle of English company law is that capital cannot generally be reduced without the consent of the court.

<sup>25</sup> Restrictions on the return of capital to shareholders see *Companies Ordinance* s 49K, s 49L, and s 49M.

- 3 Can a company (corporation) pay dividends out of unrealised profits? Yes in America.<sup>26</sup> No in the United Kingdom.<sup>27</sup> No in Hong Kong.<sup>28</sup>

In the United Kingdom, company law and the attendant financial reporting regulation were developed in the 19th century largely with the protection of creditors in mind. To quote Hong Kong's leading expert on securities and corporate law, and to apply it equally to Hong Kong company law with reference to the protection of creditors and financial reporting: "The developments of the business world have left the law far behind."<sup>29</sup>

In the United States, federal law only started to legislate on financial reporting after The Securities and Exchange Act 1934 which regulates the trading of the securities of public companies and *not* the accounts of all companies, in contrast to the British Companies Act and the Hong Kong Companies Ordinance. The underlying logic is that the Securities and Exchange Commission (SEC) and its statutory power to regulate accounting were created to protect investors in stock markets, and to protect the public interest in the stability and soundness of financial markets after the Crash of October 1929. Creditors in the United States are expected to protect themselves in other ways using their own devices such as debt covenants.

Examining the Sherron Watkins principle as a single precept that can be clearly understood by accountants and laymen alike, we pursue the question doggedly. Is it enshrined in law or is it rather a central tenet of accounting principles? Indeed, is it even correct in USA, UK and Hong Kong law and accounting? We find ourselves unable to answer these questions as clearly as we would like. It is certainly implicit in the way that American companies account for treasury stock.<sup>30</sup> There are two methods, the cost method and the par value method, but in neither case does any gain or loss on trading treasury stock impact the Income Statement. Gains are credited to the US equivalent of a share premium account (paid-in capital in excess of par) and losses may be charged against revenue reserves.

<sup>26</sup> See n 23 above.

<sup>27</sup> See n 24 above.

<sup>28</sup> See s 79B, applying across the board to all companies, private or public, listed or unlisted, except for investment companies exempted by the Financial secretary under s 79D. Betty Ho explains the significance of these provisions in the Companies Ordinance with clarity: "a company may not pay dividends out of profits for the current year without 'making up' for losses of previous years. Secondly, a company may not pay dividends out of unrealised gains." Betty Ho, *Public Companies and their Equity Securities Principles of Regulation under Hong Kong Law* (The Hague: Kluwer Law International, 1998), p 227.

<sup>29</sup> See Ho (n 28 above), p 23.

<sup>30</sup> "Treasury stock" is the American expression used in financial statements to describe shares which have been purchased by a corporation and kept for future resale. They are, therefore, not retired on repurchase as the shares in a British or a Hong Kong company would be in similar circumstances. Treasury stock is shown on the balance sheet as a reduction (debit balance) set against the equity of the company (credit balance).

Given that British companies are not allowed to own or trade their own shares the issue of gains and losses on such trades does not arise directly in British company law in the same way as it does in accounting for treasury stock in the USA. Nevertheless, implicit in the way that financial statements are prepared and published is the undeniable fact that the equity in the balance sheet is supposed to represent the shareholders' claim on the assets of the company. Logically, therefore, the size of the claim can be increased by increases in the value of the assets, but the value of the assets cannot be increased by increases in the value of the equity securities themselves, unless the company invests in (purchases) its own securities, creating a circular chain of value which it is difficult to represent. This is the reason why treasury stock is presented in the financial statements as a reduction in equity rather than as an asset belonging to the corporation.

The Sherron Watkins principle is one which was violated by the widespread American practice of accounting for mergers as a pooling of interest, in which it was possible for a corporation to "buy" accounting earnings with its own stock by merging with a more profitable company in the course of a financial year and consolidating the merged company's results for the year. Merger accounting or "pooling" has now been outlawed by the American Financial Accounting Standards Board – a major victory for Chairman Edmund Jenkins who achieved this victory in the face of enormous opposition from businessmen and politicians.<sup>31</sup> This achievement may easily be overlooked in the attempt to castigate the Financial Accounting Standards Board for its failure to regulate SPEs adequately.

It has also been argued by Mr Jeffrey Skilling<sup>32</sup> that the Sherron Watkins principle was "wrong" by pointing to the widespread use of executive stock options which reduce compensation expense by promising to issue stock in the future. The argument used is not persuasive since the Watkins principle is only claimed to apply to the booking of gains or the avoiding of losses.<sup>33</sup> Ms Watkins does not state that the reduction of expenses offends against her principle. Nonetheless, Mr Skilling's example is useful in defining the principle more closely. Mr Skilling has stated that he relied on Andersen's approval of the Raptor transaction as being appropriate. He also has pointed out that he is not an accountant.

<sup>31</sup> For a more complete description of the issues raised by the prohibition of pooling, see John Whitman and Anne Carver, "Purchase, Pooling and the Playing Field," in Horn, Norbert (ed), *Cross Border Mergers and Acquisitions and the Law, Studies in Transnational Economic Law Volume 15* (The Hague: Kluwer Law International, 2001), pp 331–345.

<sup>32</sup> Skilling was giving verbal testimony in response to a question at the hearing of the Senate Commerce Committee's Subcommittee hearing on Tuesday 26 Feb 2002. Mr Jeffrey Skilling was CEO of Enron for a period of six months in 2001. A video recording of this hearing has been available at <http://www.c-pan.org/enron/index.asp>. A transcript of the hearing will be provided later at the website of the Commerce Committee.

<sup>33</sup> The term "losses" is used to describe falls in the value of assets. Expenses would typically involve expenditure. There is a clear and important distinction here.

In the case of the Raptor transaction there was also the attendant danger that the stock might be watered down as a result of Enron's guarantee to Raptor. This was an important part of Watkins' reservations. By underwriting the special purpose entity against losses arising from the put option that Enron had purchased from it, Enron was "artificially" inflating earnings and putting the shareholders investment at risk of dilution from the forced issue of additional shares. This was clearly an ingenious and complex piece of creative accounting, but was it fraud? This remains to be seen. It is a clear concern of many of the Congressmen investigating the Enron collapse that justice be seen to be done.

We are left with the uncomfortable feeling that the Sherron Watkins principle is ethically sound in supporting a clear and transparent view of a company's financial position, but is nowhere enshrined explicitly in law. Perhaps this is one reason why Sherron Watkins believed that her Chairman, Kenneth Lay, did not "get it". "Did [Mr. Lay] understand the implications of what you were telling him?" asked Committee Chairman Billy Tauzin, a Louisiana Republican. She responded, "I don't think he did", adding that his lack of understanding was made clear when he played down the partnership problem at an October employee meeting called to discuss the company's increasingly dire straits.<sup>34</sup>

### Accounting Standards: a Comparative Perspective

Hong Kong's accounting standards are themselves under the spotlight as a result of the reforms in corporate governance, changes to the Companies Ordinance and the legislative lag of the Securities and Futures Bill. There are also uncomfortable home truths revealed by the Enron inquiry about where the legislative power lies and about the accountability of auditors and directors in law. If we accept the importance of accounting standards for Hong Kong, the question then becomes one of establishing who is responsible for setting the accounting standards in the USA, the UK and Hong Kong and examining the sources of legislative power in each jurisdiction. With many questions facing Hong Kong's terms of reference for its future as a financial centre, the choice of a corporate governance, securities and accounting model narrows down to a basic choice between following London or New York. Hong Kong could perhaps also choose eclectically between different features of the two jurisdictions, a more difficult third choice. The Enron Congressional hearings have emphasised the significance of the choice to be made. Quite possibly, Hong Kong's legislative lag may turn out to be an

<sup>34</sup> Tom Hamburger, "Watkins Tells of 'Arrogant' Culture; Enron Stifled Staff Whistle-Blowing", *Wall Street Journal*, 15 Feb 2002.

opportunity for reflection on the underlying and essential differences between the London and New York models.

Earnings management, auditor independence, off-balance sheet finance, and the difficulties of accounting for derivative transactions such as options, especially stock options, have been the subject of professional and academic debate for many years, and have previously involved a great deal of congressional pressure on the US standard setters to moderate the severity of proposed regulations.<sup>35</sup> These issues have, however, never before given rise to such widespread public concern in the USA or in the UK, and certainly not in Hong Kong. The time has come for such issues to be addressed, not as a matter for academic debate, but as a statement of social, economic and philosophical values supporting a clearly positivist view of the legal system itself. If such accounting issues are not to be seen as a statement of values, then it becomes impossible to defend the gap between law and ethics that the collapse of Enron has so clearly emphasised.

#### *The United States' Position*

The legislative power in the USA to set accounting standards for companies listed on stock exchanges is vested in the SEC which in turn delegates its powers to the FASB.<sup>36</sup> As one commentator puts it:

“The division of responsibility between the FASB and the SEC can generally be said to be that the FASB is concerned with measurement standards, and the SEC generally restricts itself to disclosure matters ... However this distinction is difficult to maintain in practice.”<sup>37</sup>

#### *The United Kingdom's Position*

In the UK, prior to the 1985 Companies Act, British standard setters on accounting principles were held to be the experts on what was and what was not “good accounting practice”. Since 1985, and the consolidation of the Fourth European Directive into British company law, there is a much clearer

<sup>35</sup> One of the key contentious issues is the desire of the FASB to require companies to show the fair value of executive stock options as an expense in the Income Statement at the time they are granted. This proposal was eventually defeated by congressional pressure and Arthur Levitt, a former chairman of the SEC, accepts that failing to give more SEC support to the FASB may have been the biggest mistake he made in his period as Chairman. This view was expressed as verbal testimony to the Senate Banking Committee on 12 Feb 2002. The video of this hearing has been available at [http://banking.senate.gov/02\\_02hrg/021202/index.htm](http://banking.senate.gov/02_02hrg/021202/index.htm), and the full transcript of the hearing will eventually be available on the same website.

<sup>36</sup> The Financial Accounting Standards Board was created in 1973 to be a body independent of the American Institute of Certified Public Accountants (AICPA) after public (and SEC) dissatisfaction with the development of accounting principles by the Accounting Principles Board (APB), an internal committee of the AICPA.

<sup>37</sup> Michael Bromwich, “Accounting Regulation and the Law,” in Michael Bromwich and Anthony Hopwood (eds), *Accounting and the Law* (Hemel Hempstead: Prentice Hall International (UK) Ltd, 1992), p 91.

codification of accounting practices. Since 1989, the final arbiter on what is and what is not a “true and fair view” is the European Court of Justice. Nevertheless, there is, as yet, no clear decision as to whether a more legalistic approach to UK accounting standards is appropriate. Nor, it seems, is the UK keen on an equivalent to the SEC regulating its standards, believing such a public sector agency to be susceptible to political pressure. This aspect of UK accounting standard setting is discussed below under the heading “Lessons for Hong Kong” and represents a particularly instructive lesson for Hong Kong regulators in the development of Hong Kong corporate governance, accounting standards and the relationship between law and accounting in Hong Kong. In addition, the UK Accounting Standards Board (ASB) replaced the UK Accounting Standards Committee in 1990. Despite the influence of the Fourth European Directive and the codified aspects of accounting now to be found in the UK Companies Act of 1989, the ASB is still seen as essentially a self-regulating body. Recently the British system and its preference for self-regulating bodies have been strengthened by the creation of the Accounting Foundation which controls a disciplinary body designed to regulate audit practice.

This article does not attempt to set out the history of self-regulating bodies in US or UK administrative law, nor to investigate the difficult question of where the funds to finance these self-regulating bodies come from.<sup>38</sup> Nevertheless, the political question remains as important as ever: Can such bodies ever be said to be “effective” and “objective” if their funding comes from the people whose behaviour they are regulating?

*The Hong Kong Society of Accountants as a Standard Setter –  
a Self-Regulating Body*

In Hong Kong, there is a typically British system in place with the accounting standards being set by the Hong Kong Society of Accountants. One particular difference to note with the Hong Kong position is that the Hong Kong Companies Ordinance does not require the directors to provide additional information to explain where there is a discrepancy between the true and fair view and the statutory requirements. In the 1989 UK Companies Act it is

<sup>38</sup> This has been the subject of much debate in the UK. See particularly John Holland, “Self-Regulation and the Financial Aspects of Corporate Governance” (March 1996) *Journal of Business Law* 127. Holland examines the links between funding and “voluntary” relationships from the perspective of UK financial institutions. For an assessment of the public law dimension and the practical limits on self-regulation, see Tom Lowe, “Public Law and Self-Regulation” (August 1987) *Company Lawyer* 115. Self-regulation is said to be an emotive and ambiguous term. Lowe comments that a system whereby a group of persons force themselves to comply with a code is said to be “very different to self-regulation in the sense of voluntary submission to or observance of a code inspired by self-interest or particular moral belief”, p 118. In which sense do Hong Kong accountants submit to their code and professional ethics? Who funds the body? Where, ultimately, lies the coercive power of law that legitimates the rule-book of the professional body?

implied that there will be no discrepancy between the statutory requirements of company law and the true and fair view since the directors are obliged to provide additional information in the event of such a discrepancy. Hong Kong currently falls somewhere in the middle between the US and UK standards and the true and fair view and responsibility put on the directors to explain discrepancies in the accounts. It can, to date, be described as a self-regulating system.

### Lessons for Hong Kong

In February 2002 the US Senate Banking Committee conducted hearings on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies". The first hearing on 12 February consisted of testimony on the subject from the last five retired chairmen of the Securities and Exchange Commission in Washington. All of these gentlemen had suggestions for reform. The second hearing on 14 February took testimony from Sir David Tweedie and Mr Paul Volcker – Mr Alan Greenspan's predecessor as chairman of the Federal Reserve Board. Sir David Tweedie was formerly Chairman of the ASB, created in 1989, and is now Chairman of the International Accounting Standards Board (IASB) created in January 2001.<sup>39</sup> Mr Volcker is chairman of the trustees of the IASB and responsible for fund-raising.<sup>40</sup> He has also accepted an honorary appointment to oversee reforms within Andersen, the accounting firm who were, until December 2001, the auditors of Enron. Much of this second hearing consisted of discussion about the differences between the accounting standard setting process in the American tradition and in the British tradition. The question of who should finance accounting standard setting also generated concern.

At the February 12 hearing the head of the New York University accounting department was quoted on the subject of the American Financial Accounting Standards Board: "It's the old adage of an FASB rule. It takes four years to write it, and it takes four minutes for an astute investment banker to get around it."<sup>41</sup> Sir David Tweedie's testimony to the Senate Banking Committee contained, amongst other things, an explanation of the differing philosophies of accounting standard setting in the US and the UK. This is the issue on which we would like to concentrate.

<sup>39</sup> The IASB is the successor to the International Accounting Standards Committee.

<sup>40</sup> In an interesting revelation, it was disclosed that Mr Volcker had solicited funds from Enron. The company expressed an interest if they could gain sufficient access to influence the standards that were being set. The sum suggested, \$500,000 over five years, was never given.

<sup>41</sup> This quotation is attributed to Paul Brown by the Honorable Roderick M. Hills, Chairman of the SEC 1975–1977 in his written testimony, and *see* n 5 above.

“In my view, the US approach is a product of the environment in which US standards are set. Simply put, US accounting standards are detailed and specific because the FASB’s constituents have asked for detailed and specific standards ... The IASB has concluded that a body of detailed guidance (sometimes referred to as ‘bright lines’) encourages a rule-book mentality of ‘Where does it say I can’t do this’... adding the detailed guidance may obscure, rather than highlight, the underlying principle. The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard ... . Our approach requires both companies and their auditors to exercise professional judgement in the public interest.”<sup>42</sup>

We quote from Sir David’s testimony at some length because it does contrast a British with an American approach to accounting standards and therefore emphasises that there is a choice here for regulators in Hong Kong. It also raises the issue of the limits to rule making and the need for “professional judgement in the public interest”.<sup>43</sup> It raises questions about the importance of clarity and the need to educate the public if we are to restore faith in the value of the auditors’ “professional judgement” in the context of the protection of the public interest.

#### *The Law and Accounting Dilemma*

Tweedie emphasised that there is a lesson for us all in the Enron collapse: “History is full of examples of those who said ‘it couldn’t happen here’ and came to regret it.”<sup>44</sup> The relevance to Hong Kong perhaps is that it is not clear that the government or the regulators at the SFC or the Stock Exchange are sufficiently involved with accounting issues to act purposefully enough to give Hong Kong the high standard of corporate governance that its position as one of the most important financial centres in the world requires.

One perception in Hong Kong is that the government is overly influenced by business interests and finds it difficult to act independently enough to give Hong Kong the level of regulation it needs. So far, with the possible exception of the Carrian case, accounting has not truly been a political issue in Hong Kong, and certainly not a matter which raises widespread public concern. The stock market is perceived as being simultaneously a club for the wealthy businessman and a casino for the man in the street. It is not yet

<sup>42</sup> Sir David Tweedie, Testimony Senate Banking Committee, 14 Feb 2002 on Accounting and Other Investor Protection Issues raised by Enron and Other Public Companies. See the Senate Banking Committee website, <http://banking.senate.gov/02-02hrg/021402/tweedie.htm>.

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*



perceived as a custodian of the citizenry's dream of an affluent retirement. The Asian financial crisis and the subsequent fall-out has implicated accountants in the recent economic slowdown in a number of Asian countries, but that issue has not consistently hit the headlines in Hong Kong or created real media attention. Nonetheless, interest in corporate governance has continued to grow over the last 10 years, simmering on the back-burner. The real question is whether the Hong Kong government will choose between the New York model or the London model with a clear perspective on the need to identify the gaps. We need to achieve an overall coherence between law and accounting despite, or perhaps because of, the gaps between law and ethics that the Enron debate on law and unethical accounting practices has so publicly highlighted.

### *The Gap Between Law and Ethics*

Many observers credit at least part of the success of the American economy over the past eight years to the regulatory framework developed by the SEC and to the role played by Arthur Levitt, its recently retired Chairman, in cleaning up some of the abuses in the market. The legal profession is clearly implicated in the collapse of Enron and questions are now being asked about the role of Enron's legal counsel in evaluating the legitimacy of Enron's special purpose entities. Indeed, the lawyers are included in Arthur Levitt's list of the key actors in the financial system in his testimony to the Senate Banking Committee on 14 February: "Managers, auditors, directors, analysts, lawyers, rating agencies, standard setters and regulators."<sup>45</sup>

The Enron debacle has also highlighted how quickly success can turn to failure. For many years, Enron was held up as an icon of American capitalism – a most successful and innovative company. In a turn of fortunes, reminiscent of the speed and impact of the East Asian financial crisis, Enron's bankruptcy set in train a series of events the implications of which go far beyond the failure of one company, albeit one of the largest in the USA. The Enron collapse has created waves that have spread into many aspects of American economic and political life. The regulators, lawyers, accountants and investors in Hong Kong must now consider what impact the Enron events will have on the corporate governance, legal and accounting reforms in Hong Kong. At a profound level, the collapse of Enron forces us to consider the question of how we can justify unethical laws. It brings to the surface of political debate the significance of rules and morality and the role of law in a

<sup>45</sup> Arthur Levitt, Testimony Senate Banking Committee, "Hearing on Accounting and other Investor Protection Issues raised by Enron and Other Public Companies", 12 Feb 2002. This is available via the website of the Senate Banking Committee, [http://banking.senate.gov/02\\_02hrg/021202/index.htm](http://banking.senate.gov/02_02hrg/021202/index.htm).

system where it is clearly understood that rules cannot prescribe the whole of human behaviour.<sup>46</sup>

### The Paradox of Professional Testimony: the Expectations and the Reality of the Expert Witness

Enron recruited William Powers, Dean of the University of Texas Law School, to be a director of the company in October 2001 and to be Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation. This committee filed its report on the main causes of the Enron bankruptcy in the New York Bankruptcy Court on 2 February 2002.<sup>47</sup> The Powers testimony before the Senate Commerce Committee on 12 February 2002 focused mainly on the SPEs and the behaviour of various actors in the drama, including the directors, the executives and the auditors. Dean Powers testimony indicated that many people knew what was happening:

“There’s no question that virtually everyone, everyone from the board of directors on down, virtually everyone understood that the company was seeking to offset its investment losses with its own stock ... that’s not the way it’s supposed to work.”<sup>48</sup>

Powers declined to say whether he thought any laws had been broken, deferring to the Justice Department, the Securities and Exchange Commission and other agencies conducting their own probes. However, he did note that “This is very serious conduct. ... Certainly, it warrants close attention.”<sup>49</sup>

The Senators also asked for Dean Powers’ views on what needed to be done to minimise the chances of a similar disaster in the future. He replied that clearly transparency is important. Senators were disappointed that Powers had only unearthed details about a limited number of off-balance sheets partnerships, when there were approximately three thousand SPEs. The language of Powers’ testimony is a masterpiece of skirting around the question of illegality:

<sup>46</sup> In some way, the Enron collapse and the question of how to punish unethical, but legal, acts goes to the heart of the natural law versus positivist debate. It is essentially a question of how we see the rules of just conduct for universal application. The tension between our Aristotelian and Kantian selves is clearly not a subject for the Hong Kong Society of Accountants. Nevertheless, for the regulator forced to consider the social values in the Hong Kong legal system and the role of law and maintenance of its credibility and legitimacy, the tension cannot be ignored. See particularly, H. L. A. Hart, *The Concept of Law* (Oxford: Oxford University Press, 2nd edn, 1994), and Joseph Raz, “Two Views of the Nature of the Theory of Law – A Partial Comparison,” in Jules Coleman (ed), *Hart’s Postscript: Essays on the Postscript to the Concept of Law* (Oxford: Oxford University Press, 2001), pp 1–39.

<sup>47</sup> See <http://www.c-span.org/enron/powersreport.pdf>.

<sup>48</sup> David Ivanovich, “Check and balances simply broke down”, *Houston Chronicle*, 5 Feb 2002. See <http://www.chron.com/cs/CDA/story.hts/special/enron/1240696>.

<sup>49</sup> *Ibid.*

“What we found was appalling.”<sup>50</sup>

“We found a systematic and pervasive attempt by Enron’s management to misrepresent the Company’s financial condition.”<sup>51</sup>

“The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea; self-enrichment by employees; inadequately-designed controls; poor implementation; inattentive oversight; simple (and not-so simple) accounting mistakes; and overreaching in a culture that appears to have encouraged pushing the limits.”<sup>52</sup>

“In the end this is a tragedy that could and should have been avoided.”<sup>53</sup>

Congressmen also found the testimony of Joseph Berardino frustrating and were significantly more hostile towards him as a witness. Joseph Berardino is the Managing Partner and Chief Executive Officer of Andersen, the auditors of Enron. Mr Berardino has testified twice. He has pointed out that there are serious concerns about the viability of the accounting model as it is currently used, and emphasised the need for radical reform. He has claimed that Andersen was misled by Enron about the status of at least one SPE and accepted that the firm was guilty of an error of accounting treatment in the case of another. He has questioned the validity of some of the Powers report and asked that Congressmen be patient in waiting until all the facts have emerged. The central question of why the Raptor transaction was approved has not yet been answered.<sup>54</sup>

### Why It Matters for Hong Kong Law

In the USA, the stock market has reacted strongly to suggestions of accounting irregularities even though there have been many other such irregularities revealed in previous financial scandals without creating such wide-spread anxiety. There is something about Enron that has brought the questions of auditor independence and the protection of investors to new levels of public concern. This has important implications for Hong Kong. One is that

<sup>50</sup> Testimony of William C. Powers, Jr. before the Committee on Commerce, Science and Transportation, United States Senate, p 2, available at <http://www.senate.gov/~commerce/hearings/hearings.htm>.

<sup>51</sup> *Ibid.*, p 3.

<sup>52</sup> *Ibid.*, p 5.

<sup>53</sup> *Ibid.*, p 6.

<sup>54</sup> Mr Berardino’s most recent testimony took place on 5 Feb 2002 at the US House of Representatives’ Committee on Financial Services.

accounting irregularities can be damaging in ways that are hard to predict. The price of stock market stability is eternal vigilance by the regulators. Perhaps an even more serious issue for the legal system is the need to recognise that the gaps in the legal system that we identify as morality are as much a part of our belief system as are the legal rules themselves.

When a chairman with a PhD in economics allows his company to collapse with serious accounting irregularities<sup>55</sup> and is allowed to maintain plausible deniability of wrong-doing, we must question if the problem lies within the law itself. Or does the problem lie in the lack of the recognition of the difference between law and ethics and the role that each plays in our positivist system? According to Senator Gordon Smith, R-Ore:

“The sorrow I feel is that our confidence in free markets is so shaken by this episode . . . . But I say to people who wonder about this: ‘this is not capitalism, this is a conspiracy that may be a crime’.”<sup>56</sup>

The Enron hearings create a realisation that the certainty of accounting principles and, possibly, the role of professional ethical codes of conduct themselves cannot work together in a sufficiently coherent manner to provide that certainty for us. We therefore have to look at the question of ethics somewhat differently. We need to identify the current role of the Hong Kong Society of Accountants as standard setters as an essentially ethical role in the gap between law and accounting.

#### *Should We Leave It to The Hong Kong Society of Accountants?*

We believe Sir David Tweedie is correct in identifying overly precise regulation as part of the problem of policing financial reporting. We are also convinced by Arthur Levitt’s characterisation of financial reporting in the United States as a “culture of gamesmanship”. He has said: “At Enron and throughout much of corporate America, optics has replaced ethics.”<sup>57</sup>

His accusation is that the balance sheet has become a lens through which the true performance and financial health of a public company can be magnified, exaggerated and distorted. He claims that this is more an ethical failure than a regulatory failure, and that the failure is “systemic”.

<sup>55</sup> We are happy not to attribute criminal behaviour to any actor until it is proven. Several Congressmen have been less circumspect.

<sup>56</sup> Julie Mason, “Lawmakers roast Lay for firm’s fall”, *Houston Chronicle*, 13 Feb 2002, at <http://www.chron.com/cs/CDA/story.hts/special/enron/1252641>.

<sup>57</sup> Prepared Statement of The Honorable Arthur Levitt, Jr. Oversight Hearing on “Accounting and Investor Protection Issues raised by Enron and Other Public Companies”, Tuesday, 12 Feb 2002. This statement is available on the website of the Senate Banking Committee at [http://banking.senate.gov/02\\_02hrg/021202/index.htm](http://banking.senate.gov/02_02hrg/021202/index.htm).

Each view highlights the need for accountants to have clear principles and to apply them, if necessary, against the wishes of company management and directors. Despite the general characterisation of accountants and auditors as unimaginative and colourless, it would seem that they cannot be constrained by well-formulated rules. We argue that both statements highlight a gap in a legalistic approach to financial reporting which appears ultimately to need filling by the professional standards of the accounting profession, despite the fact that for the most part, the training of accountants does not usually emphasise ethics, the limitations to rules or the need to identify general principles and moral values.

The difficulties of the current financial reporting model in Hong Kong are highlighted by a simmering dispute between the Stock Exchange and the Hong Kong Society of Accountants. On 1 April 2001, the Stock Exchange announced a change to the listing rules in order to allow:

- 1 listed issuers and listing applicants, which have or are to have a primary listing on the Exchange, to adopt IAS; and
- 2 overseas-incorporated listed issuers and listing applicants, which have or are to have a secondary listing on the Exchange, to adopt US GAAP.<sup>58</sup>

The HKSA had indicated its reservations to the Stock Exchange and to regulators in a letter on 17 November 2000, during the consultation period on the use of International Accounting Standards.

“While we believe that, with some modification, the US GAAP proposal could probably be adopted without causing too many difficulties, the IAS proposal carries some significant regulatory risks if it were to be introduced at the present time.”<sup>59</sup>

Later, the HKSA obtained an Opinion from Counsel on the possibility of reconciling the Stock Exchange’s position with the Companies Ordinance. We quote directly from Counsel’s Opinion on this “flawed” announcement by the Stock Exchange.

“I think that the announcement made on 1 April 2001 by the Stock Exchange of Hong Kong is flawed insofar as that announcement might be

<sup>58</sup> Stock Exchange News Release, 1 Apr 2001. A copy is at <http://www.hkex.com.hk/news/hkexnews/0401news.htm>.

<sup>59</sup> This letter was made available to members of the HKSA through the Society’s website at [www.hksa.org.hk](http://www.hksa.org.hk).

regarded as applicable not merely to companies incorporated outside Hong Kong but also to Hong Kong incorporated companies.”<sup>60</sup>

It is worrying that such an important part of the regulatory framework is vulnerable to such ambiguous territorial disputes. Given the difficulty of making sense of the complementary roles of the exchanges, the regulators, the executive and the legal and accounting professions it would seem as though Hong Kong requires the services of a full-time chairman of an Accounting Standards Board who could personify the authority of the standard setter in defining the public interest in high quality accounting standards. The lack of an Accounting Standards Board is the most obvious gap when comparing the regulatory financial framework in Hong Kong with London and New York.

Counsel’s opinion is useful in giving a recent summary of the notion of a “true and fair view”. He refers first to earlier opinions on the “true and fair view” for Hong Kong law and accounting standards thus:

“In those opinions the view was expressed that ‘true and fair view’ is a legal concept. As such its interpretation in relation to any particular set of accounts is a matter to be decided by the Courts. However, the Courts would in turn look for guidance to the normal practices of professional accountants. They would treat compliance with accepted accounting principles as prima facie evidence that the accounts in question gave a true and fair view.”<sup>61</sup>

“Finally, the concept of the true and fair view is a dynamic concept. The meaning remains the same over time, but the contents could be expected to change.”<sup>62</sup>

The true and fair view, therefore, ultimately rests on what accountants regard as acceptable, and this can be expected to change over time. The Hong Kong Society of Accountants has achieved a great deal in a short period of less than thirty years since its creation in 1973, and its work is probably not given the recognition that it deserves. There are, however, some important questions raised by its apparent inability to carry the day in discussions with the Stock Exchange.

We would argue that there must be a duty on the part of all regulators to ensure that the total system is coherent and that the statutes, the standards, the listing rules and the oversight by the Securities and Futures Commission

<sup>60</sup> See <http://www.hksa.org.hk>.

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*

are consistent with one another. Perhaps the main lesson of the Enron collapse is that, as Arthur Levitt particularly has been at great pains to explain, accounting and auditing standards are central to maintaining confidence and trust in the capital markets generally as well as to the management of individual companies.

### Conclusion

The central question raised by the Enron debacle is how to fill the gap between the incomplete effectiveness of the law and the public expectation and requirement of "fairness" in the workings of the economic and legal system. A subsidiary question is how a jurisdiction can manage its role in the processes of globalisation so that the perception of poor corporate governance, (and, indeed, the reality of poor corporate governance), do not become barriers to economic development and the influx of foreign investment. The answer to these questions involves a need to finance and support the accounting profession which is patrolling the frontier between the law and the moral values of society. There is a no-man's land here that is rather uncharted territory for all of us.

After all the Congressional testimony so far, one thing is clear from the hearings, from the phone-in television programs and from discussion in the Internet chat-rooms. It might be technically possible for defence lawyers to convince a jury that what happened at Enron did not involve criminality, but in the eyes of a large part of the American public that will not be so because no one is guilty, it will be because of serious failings in the law. We shall give Congressman Henry Waxman the last word: "It is good that people who do wrong should be punished."<sup>63</sup>

<sup>63</sup> BBC World Service News, 26 Feb 2002.