In being shut down. by mid-2004, despite mark

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In 2002, CAO went into options trading, an area of tradingboth the Management and Board were unfamiliar with. Previously, CAO dealt onlyin derivatives of futures and swaps for both hedging and speculative purposes. In mid-2003, it started trading in speculative derivative options to boost itsprofile in the market. However, it did not properly assess the risks from suchtrades, since its existing risk management system was designed for swaps andfutures trading and not speculative options derivative trading (Farhan, 2014).

Its " commencementof speculative options trading in the first quarter of 2003, without putting inplace a proper risk management environment, raised questions on the strength ofits corporate governance" (PricewaterhouseCoopers, 2004). 1. 1. Failure to Follow Internal Control PoliciesThere were internal controls implemented at CAO to limittrading losses. For instance, each trader in the company was capped to a losslimit of US$200, 000 and once exceeded, the system would automatically notifythe CEO and the Risk Department.

In addition, each trader's positions would beimmediately shut down if their respective losses reached US$500, 000. Since CAOonly had six traders, the maximum losses allowed should have been only US$3million (Roseme, 2007). However, Chenignored the limits and granted approval, which kept the traders' positions frombeing shut down. By mid-2004, despite mark to market losses of US$30 million, he increased the bet by buying short-dated options and sold longer-datedoptions (Farhan, 2014).

This showed thatCAO did not adhere to the controls since it exceeded its loss limits by US$547million (Roseme, 2007). 1. 2. Improper Application of AccountingPrinciplesCAO's valuation method did not comply with IAS 39 FinancialInstruments: Recognition and Measurement and FAS 133 Financial AccountingStandards No. 133, which recognise derivatives at their fair market value. CAOvalued options at intrinsic value and ignored the time value of money.

Suchvaluation errors were done throughout 2004 and resulted in accounting errorsbeing present in all quarterly disclosures (Farhan, 2014). (Refer to Appendix 1: CAO's Reported and AdjustedProfits for 2004 (PricewaterhouseCoopers, 2004))1. 3. Lack of SupervisionThere was an obvious lack of supervision in CAO, given that theRisk Department did not alert the Board about the serious problems in the firmand the Audit Committee failed to detect false reporting by Chen (Blanco & Mark, 2005).

For example, theAudit Committee did not point out the inappropriateness in using the valuationand accounting treatments or mention about the inadequate risk management foroptions trading (PricewaterhouseCoopers, 2004). Lastly, despite having Independent Directors, they were not actively involvedin verifying the financial statements and probing into the company's business (Lay Hong, 2009). Hence, both Chenand the Board overrode internal controls by taking elevated risks to avoidrealizing the losses. 1.

4. Lack of DisclosureCAO did not conduct a full and proper disclosureof its losses to its shareholders, Independent Directors, Nominee Directors, and Audit Committee (Lay Hong, 2009). The executives hidthe losses from the

Board and its Audit Committee and did not report the truefinancial situation to its investors throughout 2004. Furthermore, CAO’s BalanceSheet did not register the presence of options since the activity started in2002.

Lastly, CAO’s Non-Executive Directors who also worked in CAOHC failed totell the rest of the Board to stop their speculating activities, as orderedfrom Chinese government regulators in March 2002 (Prystay, 2005).