MOUNTAIN TOP UNIVERSITY

E-Courseware

SCHOOL OF HUMANITIES,

MANAGEMENT AND SOCIAL SCIENCES

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COURSE GUIDE

COURSE TITLE: Corporate Financial Reporting & Ethics

COURSE CODE: ACC 407

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COURSE OBJECTIVES

GENERAL INTORDUCTION AND COURSE OBJECTIVES

This course aims at exposing the students to corporate financial reporting and ethics. It covers: Perspectives on external reporting - The classical perspectives, ecological perspective and market perspectives; IFRS and its implication on reporting; Format and concept on income statement, statement of financial position five year financial summary, notes to the account, supplementary information and abridged financial statement; Earnings per share (basic, adjusted and Practice of Entrepreneurship diluted); Statement of accounting policies, value added statement-form and contents, cash flow statement-form and contents; air value accounting, current cost accounting; Accounting for taxations: deferred taxation. Other topics in corporate financial reporting include Financial reporting by banks and insurance companies as well as financial statement analysis.

Ethical aspects include: Philosophy of Accounting Ethics and Values. Concepts of Accounting Ethics and Values; Culture and Issues in Accounting, Ethics and the Law, compliance with standards and development; relationship with fellow members, joint engagements, special assignments and other assurance services. concept of integrity, obligation, independence, public expectations; ethical standards and professional responsibilities, independence, confidentiality, securing professional work consultancy, succession arrangement, disciplinary procedure ;consequences of unethical behaviour to the individuals, the professions and the society at large; dimensions of Accounting and Business Ethics:- General Business Ethics, Professional Ethics.

COURSE CONTENTS

LECTURE ONE

AN OVERVIEW OF CORPORATE FINANCIAL REPORTING

1.0 Introduction

ACC 407 – Corporate Financial Reporting and Ethics, links with ACC 101, ACC102, ACC 201, ACC 202, ACC 301 and ACC 302. A review of financial reporting process will be made to harmonize the knowledge gained so far in financial accounting and reporting. This lecture covers perspectives on external reporting, introduction to IFRS and a review of components of financial statements.

Objectives

At the end of this lecture, students should have a good understanding of:-

a) Perspectives on external reporting
b) IFRS and its implications on financial reporting
c) Contents of financial statements

Pre-Test

1. Attempt a definition of financial reporting?
2. What is IFRS?
3. List the components of financial statement?

CONTENT

1.1 Perspectives on External Reporting

In any industry, whether manufacturing or service, we have multiple departments, which function day in day out to achieve organizational goals. The functioning of these departments may not be related, but at the end of the day, they are linked together by one common thread – Accounting & Finance department. The accounting and financial aspects of each and every department are recorded and are reported to various stakeholders. This is referred to as external reporting. However, there are different schools of thought on accounting perspectives. Some of such perspectives are discussed below.

1. ***Classical Perspective***

The classical perspective on accounting developed in various parts of the world during the millennia preceding the Industrial Revolution. This perspective was meant to serve the dominant business organization of the day - the traders. Today, the oldest available codification of this system is Part 1, Section 9, Treatise 11 of Pacioli's *Summa de Arithmetica, Geometria, Proportioni et Proportionalita (Review of Arithmetic, Geometry and Proportions*), entitled "Particularis de Computis et Scripturis" (Particulars of Reckonings and Their Recording). This system developed in response to the personal needs of the wealthy, the merchants, and their businesses.

The classical perspective on accounting included counting, recording, and communication. Counting became necessary in civilizations where quantities larger than four or five had to be handled. Human cognitive ability to discriminate among various quantities diminishes sharply beyond this threshold. Recording was an aide-mémoire for those whose affairs included so many transactions over periods of time that memory could not be relied on to keep track of the resource flows. The communication function of accounting is exemplified in the baked clay tablet, sent by the wife of a merchant, listing the merchandise sent from home in ancient Sumeria, now displayed in a museum. The view of accounting that relies on these three basic functions can be labeled the classical view. This is codified by Paciolo in his treatise. This form of accounting, designed for simple form organizations, has long been known as bookkeeping model. Even to this day, bookkeeping is what laymen understand accounting to be.

Stewardship Perspective

Stewardship accounting evolved to address the separation of ownership and control. It adds the interests of two parties to the counting and recording aspects of accounting recognized in the classical perspective. The aide-mémoire function of accounting is important even in organizations that have only a single layer of management, usually consisting of the sole proprietor. When organization expands to include two or more levels of management, a new problem arises. Now accounting must include not only the one who gives account but also the one who takes account.

It is easy to see that stewardship played an important role in the accounts of temples and sovereigns since antiquity, as well as merchants or lords of manors who employed people (stewards) to handle the estates for them. The essence of the stewardship view of accounting is to see the problem that accounting solves as the problem of organizations. Organizations differ from individuals in that they involve actions, thoughts, information, and motives of more than one person. The stewardship view can be differentiated from the classical view of accounting in its emphasis on accounting as the solution to the problem of organizations. The fundamental problem of running organizations is that no one person in the organization has all the information in his or her possession. Since people acquire most of the information needed for doing their jobs on the job itself, they have preferential, even exclusive access to such information.

A branch of the stewardship perspective, labeled the agency theory of accounting, tries to deal with the consequences of the combination of this information asymmetry with the private interests of individuals. Diversity of private interests motivates individuals to utilize the information in their possession to advance their own interests, which may diverge from the corporate interests. This goal incongruence is the focus of agency theory, and most attention in this perspective is centered on ways of minimizing its impact.

Accounting apparatus developed to deal with the stewardship problems has come to be known as managerial accounting model. Planning and budgeting, divisional and managerial performance evaluation and compensation, decentralization, transfer pricing, capital budgeting, and activity-based costing are all concerned with the problem of control in organizations with managerial hierarchy. Managerial accounting is built on the foundation of the basic accounting records of bookkeeping and therefore encompasses it. But accounting needs of large, hierarchical organizations need all these additional features that were either absent or present only in their embryonic forms in Paciolo's description of accounting practice.

Capital Market Perspective

Acquisition of equity capital from a large number of small shareholders who do not and cannot be in direct contact with the operations of the enterprise or with those hired to manage it leads to another aspect in the range of functions accounting must perform. The modern financial reporting model is designed to operate such organizations. Publicly held corporations, a liquid stock market for trading their shares, and a system of accounting that was capable of implementing and sustaining such a system had to develop.

Publicly held corporations placed new demands on accounting systems. Investors who are distant from the operations of the firm need an accounting system to protect their interests and to enforce the contract set. Recall that, having already made their capital contribution to the firm, shareholders are especially vulnerable to nonperformance of their respective contracts by the other parties in the firm. They must have reasonable assurance that, after they have made their own contribution to the firm, other agents, too, will make their contributions according to their mutual understanding. Of the three accounting models, the financial reporting model is the only one that must implement contracts among people who do not know one another. In contrast, both bookkeeping model and the managerial accounting model are designed to implement contracts among people who deal with one other directly.

4. ***Ecological Perspective***

The view of ecological perspective of financial reporting is that organizations should be responsible for the effects of their operations on the environment from which they operate. Organizations are expected to environmental impact analysis of the operations and provide remedial actions. Financial reporting of organization is expected to capture the response of the entity to environmental issues. Variants of ecological perspective include environmental accounting, financial environmental accounting, managerial environmental accounting, green accounting and corporate social responsibility.

1.2 IFRS and Its Implication on Financial Reporting

Due to advancement in information technology, the world has become a global village. In order to be able to prepare financial statements that could be acceptable internationally, countries around the world are adopting the International Financial Reporting Standards (IFRS). IASB is responsible for issuance of the standards. It is this standards and use of appropriate local GAAP that are applied when preparing and presenting financial statements.

The IASB is the board charged with responsibility for developing international accounting standards. The board is made up of 14 members that are highly skilled in accounting and each member contribute to the issue and publications of the following documents issued by the board:

• an exposure draft of the standard
• a revised International Accounting Standards (IAS)
• an International Financial Reporting Standards(IFRS)
• a final Interpretation of the IFRS interpretation committee(IFRSIC)

Thus, when IFRS is mentioned, it means:
(i) All Accounting Standards (IASs) and Interpretations by SIC published by the IASC up to 2001 (those not yet replaced) and;
(ii) All Accounting Standards (IFRSs) and Interpretations (IFRICs) published by the IABS from 2001.
Since 2001, the IASB has published the following standards using the new nomenclature IFRS:
- IFRS 1 - First time adoption of IFRS
- IFRS 2 - Share-based payment
- IFRS 3 - Business combination
- IFRS 4 - Insurance contracts
- IFRS 5 - Non-current assets held for sale and discontinued operations
- IFRS 6 - Exploration for and evaluation of mineral resources
- IFRS 7 - Financial Instruments: Disclosure
- IFRS 8 - Operating segments
- IFRS 9 - Financial instruments
- IFRS 10 - Consolidated Financial Statements
- IFRS 11 - Joint arrangements
- IFRS 12 - Disclosure of interests in other entities
- IFRS 13 - Fair value measurement
- IFRS 14 – Regulatory deferral accounts
- IFRS 15 - Revenue from contracts with customers
- IFRS 16 - Leases
- IFRS for SMEs

1.3 Conceptual Framework for Financial Reporting

The IASB has full responsibility for all technical matters and they have issued IASB – CONCEPTUAL FRAME WORK which set out the concepts that underlie the preparation and presentation of financial statements for users.

A conceptual framework is a set of concepts and principles which underpin the preparation of financial statements. It is a framework upon which IFRSs are based and so determined the information contained in financial statements. The framework comprised of the following sections:

a) The objective of financial statements
b) Underlying assumptions of financial statements
c) The qualitative characteristics that determines the usefulness of information in financial statements
d) The definition of the elements of financial statements
e) The recognition of the elements of financial statements
f) The measurements of the elements of financial statements
g) Concepts of capital and capital maintenance

Purposes of conceptual framework:

i. it assist preparers of financial statements in applying IFRSs and in dealing with matters not yet covered by any IFRS.
ii. It assists users when interpreting the information contained in IFRS complaint financial statements.
iii. It assists auditors informing an opinion on whether or not the financial statements adequately complied with IFRSs.
iv. It assists national standard setting bodies when developing their national or local standards.
v. It assists the IASB when developing new IFRSs and in the review of existing ones.

1.4 Components of Financial Statements

Before the adoption of IFRS in Nigeria in 2012, the preparation of entities financial statements were guided by the companies and Allied Matters Act 2004 and existing local and international accounting standards. The components of financial statements under that jurisdiction were:

1. Profit and loss account
2. Balance sheet
3. Cash flow statement
4. Value Added Statement
5. Statement of accounting policies
6. Notes to the accounts

With the adoption of IFRS as the financial reporting standards in Nigeria, entities financial statements are now required to comply with the provisions and requirements of applicable IFRSs. A complete set of IFRS financial statements consists of the following components:

a) Statement of profit or loss and other comprehensive income
b) Statement of changes in equity
c) Statement of financial position
d) Statement of cash flows
e) Notes to the financial statements, comprising a summary of significant accounting policies and other explanatory information

a. Statement of profit or loss and other comprehensive income

This statement presents the financial performance of an entity for a reporting period. It is the IFRS statement which replaces the old trading, profit and loss account. In this statement, items of income and expenses are classified and present either by nature or by function (cost of sales method) and will require disclosure either in the face of the statement or the notes.
The statement sometimes is prepared in two separate sections as:

i) Statement of profit or loss
ii) Statement of other comprehensive income

b. Statement of changes in equity

This statement is introduced as a new component of an entity's financial statements under IFRS. It replaced the appropriation section of the trading, profit and loss accounts. The statement shows an entity's profit or loss for a reporting period, items of income and expenses recognized in other comprehensive income for the period, the effects of changes in accounting policies and corrections of errors recognized in the period, and the amounts of investments by, and dividends and other distributions to, entity investors during the period. In summary, it shows the movement in the equity section of the statement of financial position.

c. Statement of financial position

The statement of financial position is the IFRS name for balance sheet. It shows the assets, liabilities and equity of an entity at the end of a reporting period or year. The assets and liabilities are sub-classified into non-current and current in the statement.

d. Statement of cash flows

The statement of cash flow gives information about the changes in cash and cash equivalents of an entity for a reporting period. In the statement, cash flows and outflows are classified according to activities which are operating, investing and financial activities. The statement attempts to reconcile the opening balance of cash and cash equivalents to its closing balance. Cash equivalents are short-term highly liquid investments held to meet short-term cash commitments rather than for investments or other purposes.

e. Notes to the financial statements

Accounting permits information to be presented either in the face of financial statements or in the notes. The notes may contain significant accounting policies and other explanatory information. Financial statements are better understood when taken together with the accompanying notes.

Post-Test

1. Bookkeeping model evolves from ………. A. Classical Perspective B. Stewardship Perspective C. Market Perspective D. Ecological Perspective
2. ……………………... evolved to address the separation of ownership and control. A. Stewardship accounting B. Managerial Accounting C. Cost Accounting D. Environmental Accounting
3. ………….. are short-term highly liquid investments held to meet short-term cash commitments rather than for investments or other purposes. A. Cash B. Cash equivalents C. Preference Shares D. Debentures
4. …………….. replaced the appropriation section of the trading, profit and loss accounts. A. Income Statement B. Statement of Comprehensive Income C. Statement of Changes in Equity D. Value Added Statement
5. IFRS 16 is on ………. A. Leases B. Fair Value C. Insurance Contract D. Share-based Payment

THEORY

1. Write short notes on the following financial reporting perspectives: Classical Perspective, Stewardship Perspective, Market Perspective and Ecological Perspective.
2. What is Conceptual Framework for Financial Reporting? List five purposes of the Conceptual Framework.

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LECTURE TWO
SUPPLEMENTARY INFORMATION IN FINANCIAL STATEMENTS

1.0 Introduction

IFRS has stipulated the minimum information that must be contained in financial statements. However, additional information may be made. Such information includes directors' report, five-year financial summary and value added statement and form the contents of this lecture.

Objectives

At the end of this lecture, students should have a good understanding of:-

d) Contents of directors' report
e) Five-year financial summary
f) Value added statement

Pre-Test

1. Who are the directors of a company?
2. What do you understand by a small company?

CONTENT

1.1 Contents of directors' report

Section 342 of CAMA 2004 (as amended) stipulates that directors of a company should disclose the following information among others as part of the content of directors' report:

1. A fair view of the development of the business of the company and its subsidiaries during the year and of their position at the end of the year.
2. Amount recommended to be paid as dividend.
3. Amount of profit proposed to be carried to reserves.
4. Names of persons who were directors of the company at any time during the year.
5. The principal activities of the company and its subsidiaries and any significant change in those activities during the year.
6. Donations and gifts made
7. Five-year financial summary
8. Value added statement
9. Small companies
10. Modified financial statement

2.2 Five year financial summary

The five year financial summary is an abridged profit or loss account and statement of financial position of the last five years together with additional information like earnings per share, dividend per share and price earnings ratio (P/E Ratio). The purpose of this information is to allow for observation of trends in performance and growth of the company over the years.

2.3 **Value Added Statement**

Value added represents the additional wealth which the company was able to create by its own and employees' effort. The value added statement shows the allocation of that wealth between the employees, government, providers of finance (shareholders) and the amount retained for further expansion. The statement of value added is not required as an integral part of the financial reporting by IFRS.

Format of the value added statement

	N	N	%
Sales		X	
Add other income		X	
Bought in goods & service		(X)	
Total Value added		X	100
Applied as follows:			
To pay employee			
Salaries and wages	X		
Staff welfare and medical	X		
Employees compensation	X		
		X	X
To government			
Taxation		X	X
To providers of capital			
Dividend paid	X		
Interest paid	X		
		X	X
For growth & expansion			
Depreciation	X		
Retained profit for the year	X		
		X	X
		X	100

Note: Some organizations treat depreciation as part of the bought in goods and service while others regard it as application of value-added.

2.4 Illustration

The following is the income statement of Asaolu Plc for the year ended 31 December 2010.

	N'000
Revenue	14,191
Cost of sales	(11,239)
Gross profit	2,952
Other operating income	257
Profit from main Business	3,209
Operating expenses	(2,651)
Interest expense	(213)
Profit before tax	345

Taxation	(91)
Profit after tax	254

Notes

1. Interim dividend of N252, 000 was paid during the year.
2. Included in distribution and administration expenses are

	N'000
Salaries and wages	166
Depreciation	121

Required: Prepare the statement of value added for the year ended 31 December 2010.

Solution

ASAOLU PLC

Statement of value ADDED FOR THE YEAR ENDED 31 December 2010.

	N'000	N,000	%
Revenue		14,191	
Other income		257	
		14,448	
Bought in goods and services		(13,603)	
Value added		845	100
Applied as follows:			
To pay employees			
Salaries and wages		166	19.6
To pay government			
Taxation		91	10.8
To providers of capital			
Interest	213		
Dividend paid	252		
		465	55.0
For growth & expansion			
Depreciation	121		
Retained profit (254-252)	2		
		123	14.6
		845	100

Post-Test: MCQ

1. What section of CAMA 2004 (as amended) covers the contents of directors' report?
A. Section 243 B. Section 324 C. Section 342 D. Section 432
2. The value added statement shows the allocation of wealth of a business among the following stakeholders EXCEPT ……….. A. Employees B. Creditors C. Government D. Shareholders
3. Which of the following components of value added statements can be applied for growth and expansion of the business? A. Deferred tax B. Accrued Wages C. Provision for Bad Debt D. Depreciation
4. The difference between Total revenue and value added is ………….. A. Total Dividend B. Retained Profit C. Tax Payable D. Bought-in Goods and Services
5. Trends in the following accounting information can be obtained from five year financial summary EXCEPT …… A. Operating Lease B. Tax C. Dividend D. Capital Structure

THEORY

1. List ten contents of directors' report

2. Outline five advantages of value added statement.
3. Explain the significance of five year financial summary.

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LECTURE THREE
SMALL COMPANIES AND MODIFIED FINANCIAL STATEMENTS
3.0 Introduction

CAMA 2004 (as amended) permits small companies to file abridged or modified financial statements with the Corporate Affairs Commission (CAC). This implies that details financial statements that must be prepared by registered public limited liability companies can be prepared in aggregates form by the companies that are qualified as small companies. The purpose is to save the small companies of the efforts and cost of preparing standard financial statements. This lecture focuses on provisions of CAMA 2004 on small companies

Objectives

At the end of this lecture, students should have a good understanding of:-

i. Small companies and conditions for qualification as small companies.
ii. Contents of modified financial statement
iii. Preparation of modified financial statements

Pre-Test

1. List the types of companies in Nigeria?
2. How can you distinguish between micro, small and medium scale enterprises?

CONTENT

3.1 Small Companies

Section 351 of CAMA 2004 stipulates that a company is qualified as a small company in a year, if for that year the following conditions are fulfilled:

1. It is a private company having a share capital
2. Its turnover is not more than N2million.
3. Its net assets value is not more than N1million.
4. None of its members is an alien.
5. None of its members is a Government or Government Corporation or Agency or its Nominee.
6. The directors hold not less than 51% of the company's shares.

3.1 Modified Financial Statements (Schedule 7 of CAMA 2004, as ammended).

Modified individual financial statements comprise:

1. Abbreviated statement of financial position, showing only those items to which a letter or Roman number is assigned in the statement of financial position. It must be signed by two directors.
2. Notes to the accounts:

a. Statement of accounting policies

b. Information on share capital and debenture
c. Allotments during the year
d. Details of payables
e. Basis of foreign currency translation
f. Corresponding figures for previous year
g. Aggregate amount of receivables
h. Aggregate amount of payables
3. A statement by the directors that they relied on sections 350 and 353 of CAMA 1990 entitling them to prepare modified financial statements.
4. Auditor's special reports stating that in their opinion:
a. The directors are entitled to deliver modified financial statements
b. The accounts are properly prepared in accordance with schedule 7 of CAMA 1990.

Post-Test

1. List the conditions to be fulfilled for qualification as a small company/
2. Outline the contents of modified financial statement?

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LECTURE FOUR
STATEMENT OF CASH FLOW
4.0 Introduction

The statement of cash flows is an integral part of the financial statement. It is covered by **IAS 7 – Statement of Cash flow.**

Objectives:

At the end of this lecture students should:

• Know the importance of the statement of cash flow as an integral part of the financial statement

• Know the differences between cash flows from operating activities, investing activities and financing activities

• Be able to prepare cash flow from operating activities using the direct and indirect method

• Be able to prepare statement of cash flow as an integral part of the financial statement

Pre-Test

1. What is cash flow?
2. List some cash inflow and cash outflow from a business entity.

CONTENT

4.1 Statement of cash flow

The statement of cash flow presents the inflows and outflows of cash and cash equivalents by category over a period of time.

Importance of the statement of cash flow

The statement of cash flow provides users with a basis to:

a) Assess the ability of the enterprise ***to meet its debt obligations***

b) Assess the entity's ability ***to generate and utilize cash***

c) Assess the ability of the enterprise ***to finance its current operations*** using its own cash or external sources of cash

d) ***Compare results of different companies in a better manner than through the traditional profit or loss basis.***

e) ***Estimate future cash flow.***

Limitations of the Statement of Cash flow

a) The statement may ***not be able to provide the required information for the future*** because it uses historical data.

b) ***Some non-cash transactions are not disclosed on the face of the statement*** but are of interest to users because they will impact on future cash flows

Differences between Statement of Cash flow and profits

1. The ***accrual accounting concepts*** are used to arrive at the profit whereas the statement of cash flows is based on the cash available during the period and the uses of this cash.

2. Statement of cash flow is ***a better measure of the ability of the entity to meet its debt obligation than profits.***

4.2 Classification of Cash Flows

The Statement of cash flows is prepared using standard headings as explained below:

1. **Operating Activities:** These are principal revenue – producing activities of the entity and other activities that are not investing or financing in nature. It is one of the important components that assist in forecasting future operation cash flows of the entity. Common examples include:

1. Cash inflows

a. Cash received from customers from sales of goods or rendering of service
b. Royalties fees, commission and other revenue received in cash
c. Income tax refunds received, unless they can be specially identified with investing or financing activities

2. Cash outflows

a. Cash payment made to suppliers of goods and services
b. Cash payments made to and on behalf of employees'
c. Income tax paid, unless the payments can be specifically identified with financing or investing activities

2. Investing Activities: These are activities of the entity that relates to acquisition and disposal of non-current assets, long-term investments and investment properties. The cash flows from investing activities represent the extent to which expenditure had been made for resources intended to generate future income and cash flow. Typical examples include:

1. Cash inflows

a. Proceed from sale of property, plant and equipment
b. Proceed from sale of investments
c. Collection of cash advances
d. Dividend received
e. Interest received

2. Cash outflows

a. Purchase of property, plant and equipment
b. Purchase of investment
c. Cash advances made to third parties

3. Financing Activities: These are activities that results in changes in the size and composition of the equity and borrowing of an entity. Cash flows from financing activities included funds provided by and paid to owners and third parties. Particular examples include:

1. Cash inflows

a. Cash received on issue of shares
b. Cash received from issuing debt instruments (debenture)
c. Proceeds from bank borrowings (Overdraft, short-term loan)

2. Cash outflows

a. Payment of dividends to shareholders
b. Repayment of principal portion of debt, including lease obligations
c. Repayment of bank borrowings

4. **Cash and Cash Equivalents**

a. **Cash** comprises cash on hand and cash with banks
b. **Cash –equivalents** are short- term, highly liquid investments that are readily convertible into known amounts of cash and that are subject to an insignificant amount of risk of changes in value.Examples are demand deposits and bank overdraft.
c. **Net increase or decrease in cash and cash equivalents** is the overall increase or decrease in cash and cash equivalents during the period. The balance of **cash and cash equivalents at the end of the year** is obtained by adding the cash and cash equivalent at the beginning of the period to the net increase or decrease in cash and cash equivalent.

4.3 Methods of preparing cash flow from operating activities

There are two methods of preparing cash flows from operating activities. The direct method and the indirect method. In practice, the vast majority of entities use the indirect method.

1. **Direct Method**

The direct method presents the items that affected cash flows and the amount of those cash flows. In other words, it presents the gross cash receipts and cash payments.

Direct method (Format)

	N'000	N'000
Cash flows from operating activities:		
Cash received from customers		X
Cash paid to suppliers		(X)
Cash paid to employees		(X)
Cash generated from operations		X
Income tax paid		(X)
Net cash from operating activities		X
Cash flow from investing activities:		
Proceeds of disposal of non-current assets/investments		X
Dividend/interest received		X
Purchase of property, plant and equipment	(X)	
Purchase of investment	(X)	(X)
Net cash flow from investing activities		X
Cash flow from financing activities:		
Cash received from issuing of shares		X
Cash received from issuing debenture		X
Proceeds from bank borrowings		X
Interest paid	(X)	
Dividends paid to shareholders	(X)	
Repayment of debenture including lease obligations	(X)	
Repayment of bank borrowings	(X)	(X)
Net cash flow from financing activities		X
Increase/(Decrease) in cash and cash equivalent		**X**
Cash and cash equivalent at the beginning		X
Cash and cash equivalent at the end		**X**

Example 1: Chuks Ltd is preparing its statement of cash flows using the direct method and has provided this information.

	N'm
Credit sale	20,000
Trade and other receivables at year end	3,000
Trade and other receivables at beginning of the year	5,000
Credit Purchases	8,000
Trade payable at year end	3,800
Trade payable at beginning of year	4,000
Operating expenses incurred	6,000
Accrued expenses, beginning of the year	1,000
Accrued expenses, end of the year	800
Depreciation of property, plant and equipment	1,200
Tax paid	3,200

Required: Prepare the cash flows from operating activities using the direct method.

Solution:	N'm
Cash flows from operating activities:	
Receipt:	
Cash received from customers (w1)	22,000
Payment:	
Cash paid to suppliers (w2)	(8,200)
Operating expenses (w3)	(5,000)
Cash generated from operations	8,800
Income tax paid	(3,200)
Net cash from operating activities	5,600

WORKINGS

1. Receivables a/c

	N		N
Bal. b/d	5,000	Cash	22,000
Sales	20,000	Bal. c/d	3,000
25,000		25,000	

2. Suppliers a/c

	N		N
Bank	8,200	Bal. b/d	4,000
Bal. c/d	3,800	Purchases	8,000
12,000		12,000	

3. Accrued Operation expenses a/c

	N		N
Bank	5,000	Bal. b/d	1,000
Depreciation (PPE)	1,200	P&L a/c (operating expenses)	6,000
Bal. c/d	800	7,000	
7,000			

2. **Indirect Method**

Under this method, the profits or loss is adjusted for the effects of transactions of non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expenses associated with investing or financing cash flows. Transactions of non-cash nature include:

i. Depreciation
ii. Provisions
iii. Profit or losses on the sale of assets

Indirect Method(Format)

Cash flows from operating activities:	N,000	N'000
Profit before taxation		X
Adjustment for:		
-Add Depreciation	X	
-Add Income from investment	X	
-Add Interest expense	X	X
Operating cash flow before changes in working Capital		X
Changes in working capital:		

Add decrease in inventories/trade receivables/ Prepayment	X	
Less increase in inventories/trade receivables/ Prepayment	(X)	
Add Increase in payables/accruals	X	
Less decrease in payables/accruals	<u>(X)</u>	<u>X</u>
Operating cash flow after changes in working Capital		X
Tax paid		<u>(X)</u>
Net cash flows from operating activities		<u>X</u>
Cash flow from investing activities:		
Proceeds of disposal of non-current assets/investments		X
Dividend/interest received		X
Purchase of property, plant and equipment	(X)	
Purchase of investment	<u>(X)</u>	<u>(X)</u>
Net cash flow from investing activities		<u>X</u>
Cash flow from financing activities:		
Cash received from issuing of shares		X
Cash received from issuing of debenture		X
Proceeds from bank borrowings		X
Interest paid	(X)	
Dividends paid to shareholders	(X)	
Repayment of debenture including lease obligations	(X)	
Repayment of bank borrowings	<u>(X)</u>	<u>(X)</u>
Net cash flow from financing activities		<u>X</u>
Increase/(Decrease) in cash and cash equivalent		**X**
Cash and cash equivalent at the beginning		<u>X</u>
Cash and cash equivalent at the end		**<u>X</u>**

Example 2: Ajileye Ltd has provided the following information

N'm	
Profit before tax	800
Depreciation on PPE	400
Loss on sale of building	200
Interest paid	200
Interest expenses	300
Income tax paid	100
Account received year end	1,700
Account received beginning of the year	1,000
Account payable year end	1,000
Account payable beginning of the year	400
Inventory year end	800
Inventory beginning of the year	1,000

Required: prepare the statement of cash flow from operating activities using the indirect method.

Solution

AJILEYE PLC

Statement of cash flows- indirect method

Cash flows from operating activities		
	N'm	N'm
Profit before taxation		800
Adjustment for:		
Depreciation on PPE	400	
Loss on sale of building	200	
Interest expense	300	900
		1,700
Movement in working capital:		
Increase in account receivable	(700)	
Increase in account payables	600	
Decrease in inventory	200	100
Cash flow from operation		1,800
Tax paid		(100)
Net cash flows from operating activities		1,700

4.4 Comprehensive Illustration

Ever-ready Nigeria Ltd

Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2015

	N'000	**N'000**
Turnover		2,600
Cost of goods sold		(1,200)
Gross profit		1,400
Salaries, wages and General expenses	(1,040)	
Provision for depreciation	(200)	
Interest on loan note	(40)	
		(1,280)
Profit before taxation		120
Income tax expense		(25)
Profit for the year		95

Statement of Financial Position as at 31 December 2015

	31 December 2015		**31 December 2014**	
	N'000	**N'000**	**N'000**	**N'000**
Non-current assets (Cost)	1800		1520	
Accumulated depreciation	(920)		(720)	
		880		800
Current assets				
Inventories	160		230	
Trade Receivables	60		80	
Bank	80		40	
	300		350	
Current liabilities:				

Tax	25		30	
Trade payables	110		100	
Accrued wages	10		20	
Dividend	20		-	
	165		150	
		135		200
		1,015		1,000
EQUITY & LIABILITIES:				
Ordinary shares		400		400
Retained earnings		255		200
		655		600
10% loan notes		360		400
		1,015		1,000

You are **required** to prepare statement of cash flows for the year ended 31 December 2015 using (i) direct method and (ii) indirect method (Show all workings).

Solution

(a)

EVER-READY NIGERIA LIMITED
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2015
(DIRECT METHOD)

	N'000	**N'000**
Cash flow from operating activities:		
Cash flow from customers w1		2,690
Cash paid to suppliers w2		(1,190)
Cash paid to employees w3		(1,050)
Cash flow from operating activities		450
Tax paid w4		(30)
		420
Cash flow from investing activities:		
Purchase of non-current asset		280
		140
Cash flow from financing activities:		
Loan repayment	(40)	
Dividend paid w5	(20)	
Interest paid	(40)	
		(100)
Net increase in cash & cash equivalents		40
Cash and cash equivalent at Jan. 1		40
Cash and cash equivalent at Dec 31		80

WORKINGS

W1

Cash flow from customers

	N'000
Turnover	2,600
Decrease in inventory	70
Decrease in receivable	20
	2,690

W2

Cash Paid to Suppliers

Trade payable control a/c

	N'000		N'000
Bank (balancing fig)	1,900	Balance b/f	100
Balance c/d	110	Cost of goods sold	1,200
	1300		1300
		Balance b/d	110

W3

Cash Paid to Employers

Accrued wages control a/c

	N'000		N'000
Bank (balancing fig)	1,050	Balance b/f	20
Balance c/d	10	Salary & wages for the year	1,040
	1,060		1.060
		Balance b/d	10

W4

Tax paid

Tax payable a/c

	N'000		N'000
Bank (balancing fig)	30	Balance b/f	30
Balance c/d	25	Income tax for the year	25
	55		55
		Balance b/d	25

W5

Dividend Paid

Retained Earnings a/c

	N'000		N'000
Dividend	20	Balance b/f	200
Bank(balancing fig)	20	Profit & Loss	95
Balance c/d	255		
	295		295
		Balance b/d	255

(b)

EVER-READY NIGERIA LIMITED

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2015

(INDIRECT METHOD)

	N'000	**N'000**
Cash flow from operating activities:		
Profit before taxation		120
Adjustments:		
Add depreciation	200	
Add Interest expenses	40	240
Cash flow from operation before changes in Working capital		360
Changes in working capital:		
Add decrease in inventory	70	
Add decrease in trade receivable	20	
Add increase in trade payable	10	

Less decrease in accrued wages	(10)	90
Cash flow from operating activities		450
Tax paid w4		(30)
		420
Cash flow from investing activities:		
Purchase of non-current asset		280
		140
Cash flow from financing activities:		
Loan repayment	(40)	
Dividend paid w5	(20)	
Interest paid	(40)	
		(100)
Net increase in cash & cash equivalents		40
Cash and cash equivalent at Jan. 1		40
Cash and cash equivalent at Dec 31		80

Post-Test

1. List 5 importance and 4 limitations of statement of cash flow. State 2 differences between statement of cash flow and profit.
2. List the 3 major sections in the statement of cash flow and give examples of cash inflows and cash outflows in each section.
3. Differentiate between direct and indirect methods of preparing cash flow from operating activities.

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LECTURE FIVE
FINANCIAL REPORTING BY BANKS

5.0 Introduction

SAS 15 Accounting by Banks and Non-Bank Financial Institutions (Part II) is a Nigerian standard called statement of accounting standard (SAS). The standard applies to non-bank financial institutions including Financial Houses, Bureau De Change, Mortgage Institutions, Discount Houses, Stock Brokerage Firms and Other Capital Market Operators. It also applies to a bank when it engages in any of the above activities.

Objectives

At the end of this lecture, students should be able to prepare:-

1. Income statement of banks
2. Statement of Financial Position of Banks

Pre-Test

1. Identify some sources of revenue to banks?
2. List some of the expenses of a banking business?
3. List assets and liabilities of a banking business?

CONTENTS

5.1 Income Recognition

Income not in doubt should be recognized on accrual basis (as earned in the accounts). But when collection of interest on loans and advances is in doubt, it should be recorded on cash basis (when received). Otherwise interest earnings should be accrued for in proportion to the outstanding principal over the period of the loans and advances. Credit fee income from credit facility, where material and its collection is not in doubt, should be deferred and allocated to income, net of related expenses, over the life of the credit facility.

5.2 Loss Recognition

General and specific provisions should be made for doubtful loans and advances, leases and off-balance sheet facilities. Long term and short term investments should be carried in the books at the lower of cost and net realizable value.

5.3 Income Statement

The following items of income and expenses should be shown separately:

INCOME

1. Interest and discount income
2. Lease finance income
3. Fees for services rendered
4. Foreign exchange income
5. Commission income
6. Investment income

EXPENSES

1. Interest expense
2. Loan loss expense
3. Commission expense
4. Foreign exchange losses
5. General and administrative expenses
6. Diminution in asset value

5.4 Statement of Financial Position

Assets and liabilities should be grouped according to their nature, liquidity and maturity. The following items of assets and liabilities should be shown separately:

ASSETS

1. Cash
2. Short term funds and short term investments
3. Due from banks
4. Bill discounted
5. Investments
6. Loans and advances
7. Advances under finance leases
8. Other assets
9. Non-current assets

LIABILITIES

1. Deposits Fund
2. Due to bank
3. Tax payable
4. Dividend payable
5. Other liabilities
6. Long term loans

SHAREHOLDERS' EQUITY

1. Share capital
2. Statutory reserves
3. General reserves
4. Retained earnings

Post Test

The trial balance of Oyewole Bank Plc as at 31st December, 2018 is shown below:

	N'000	N'000
Share capital		600,000
Statutory reserves		90,000
General reserves (1/1/18)		120,000
Retained earnings (1/1/18)		25,000
Interest and discount income		120,000
Fees for services rendered		23,500
Foreign exchange income		50,000
Commission income		25,000
Investment income		25,000
Interest expense	10,000	
Loan loss expense	15,000	
Commission expense	5,200	

Foreign exchange losses	25,000	
General and admin expenses	8,500	
Cash	750,000	
Short term investments	100,000	
Due from banks	150,000	
Investments	200,000	
Loans and advances	50,000	
Other assets	80,000	
Non-current assets	120,000	
Deposits Fund		250,000
Due to bank		45,000
Tax payable (1/1/18)		12,500
Dividend payable (1/1/18)		22,500
Other liabilities		60,000
Long term loans		40,000
	1,508,500	1,508,500

Additional information:

1. Accrued: Loan loss expense N5,000,000; Foreign exchange losses N10,000,000; Tax N7,500,000; General and administrative expenses N3,500,000
2. Prepaid: Interest expense N2,500,000; Commission expense N1,200,000.
3. Directors have proposed N35,000,000 as dividend and recommended N25,000,000 as transfer to general reserves.

REQUIRED: Prepare income statement and statement of financial position of Oyewole Bank Plc. As at 31st December, 2018.

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LECTURE SIX

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

6.0 Introduction

A ratio could be used to express the relationship between two elements of financial data that are logically linked. Financial ratios standardize financial statement data in terms of mathematical relationships expressed in the form of **percentages** or **times**. Ratio Analysis involves computation of financial ratios and comparing these ratios with that of previous periods for the same company or with industrial average or with that of other companies in the same industry.

Financial analysis is carried out by different stakeholders for different purposes. **Creditors** focus on credit risks, the probability that the firm may default in payment of loan and interest on the loan. ***Short-term creditors*** like suppliers of goods have interest in liquidity of the firm while ***long-term creditors*** like bond holders and long-term loan grantors (commercial banks) have interest in solvency of the firm. **Investors or equity holders** are concerned with return on their investment and security of their investment. They are interested in profitability and stability of the firm. **Customers** rely on the firm for long-term supply of goods. They are interested in financial strength of the firm. **Employees** are interested in security of their jobs and increase in remunerations. They are therefore concerned with profitability and stability of the firm.

Objectives - At the end of the lecture, the student should be able to:

1. Understand the meaning, uses and limitations of ratio analysis in financial statements analysis.
2. Compute relevant financial ratios from the contents of the financial statements of a commercial organization.
3. Interpret the financial ratios.

Pre Test

1. List types of financial ratios you know?
2. List the importance of financial ratios?

Contents

6.1 Types of financial ratios

Financial ratios could be grouped into two:

Management performance ratios – Assessment of management performance usually starts with a focus on Profitability ratios followed by Assets utilization ratios/Stability ratios/Efficiency ratios.

Financial strength ratios – The ratios indicate the strength of the company's financial position from different points of view and focus on the financial risks associated with the company's financial position. The ratios include liquidity ratio, activity ratios and solvency ratios.

6.2 Profitability ratios – Profitability is a primary measure of the overall success of a company. The ratios highlight the return side of the basic risk-return relationship in business set up. These ratios include operating profitability ratios and return on investment ratios:

Operating profitability ratios: The ratios indicate how successful the management is in creating profit from a given quantity of sales.

1. **Gross profit margin** = $\frac{\text{Gross profit}}{\text{Sales}} \times 100\%$

Gross profit margin is a good metric for measuring efficiency of trading or manufacturing activities because operating expenses are not included in the cost of sales and cost of goods manufactured respectively. However, gross profit margin should be used with caution for companies which operating expenses form major part of the total expenses.

2. **Net profit margin** $= \frac{\text{Net profit}}{\text{Sales}} \times 100\%$

It is a better measure of performance than gross profit margin because operating expenses are included to arrive at net profit.

Return on investment ratios (ROI): These ratios take into account the investment needed to the profit but operating profitability ratios do not.

3. **Return on equity (ROE)** $= \frac{\text{Net profit after tax}}{\text{Equity}} \times 100\%$

4. **Return on assets (ROA)** $= \frac{\text{Net profit before interest and tax}}{\text{Total assets}} \times 100\%$

5. **Return on capital employed (ROCE)** $= \frac{\text{Net profit before interest and tax}}{\text{Equity + Long term debt}} \times 100\%$

OR

$$\text{ROCE} = \frac{\text{Sales}}{\text{Capital employed}} \times \frac{\text{Net profit}}{\text{Sales}}$$

6.3 Assets utilization ratios or Stability ratios or Efficiency ratios – The ratios measure how efficiently management uses the company's assets. It intends to reflect the intensity with which assets are employed. If a firm has a low ratio of sales to assets, it implies that assets are substantially underutilized or that assets are not being efficiently employed. The ratios consist of:

1. **Total assets turnover** $= \frac{\text{Sales}}{\text{Total assets}}$

2. **Non-current assets turnover** $= \frac{\text{Sales}}{\text{Non-current assets}}$

3. **Inventory turnover** $= \frac{\text{Cost of sales}}{\text{Av. Inventory}}$

4. **Debtors turnover** $= \frac{\text{Credit sales}}{\text{Debtors}}$

5. Working capital turnover $= \frac{\text{Sales}}{\text{Net current assets}}$

6.4 Liquidity ratios – These ratios measure the ability of the company to generate cash to meet its short-term obligations like working capital needs and immediate debt repayment needs like payment of suppliers of goods and payment of overdraft. The ratios include:

1. **Current ratio** $= \frac{\text{Current assets}}{\text{Current liabilities}}$

It depicts the ability of the current assets to off-set the current liabilities. A current ratio of 2:1 is considered optimum.

2. **Quick ratio or Acid test ratio** $= \frac{\text{Current assets – Stocks - Prepayment}}{\text{Current liabilities}}$

It is used to assess the firm's ability to honour immediate commitments from cash and cash equivalents. The numerator is the amount of the most liquid assets.

3. **Cash ratio** $= \frac{\text{Cash}}{\text{Current liabilities}}$

It is used to assess the firm's ability to honour immediate commitments from cash.

6.5 Activity ratios – These are ratios that reflect the cash elasticity of current assets. That is, the degree of converting current assets (stocks and debtors) to cash. The ratios include:

1. **Average stock turnover** = $\dfrac{\text{Cost of goods sold}}{\text{Average stock}}$

This ratio divides 365 days to determine the average length of time that stocks are held before being sold (365 days/Av. Stock turnover ratio).

Note: Average stock = $\dfrac{\text{Opening stock + Closing stock}}{2}$

OR

Days inventory outstanding = $\dfrac{\text{Average stock}}{\text{Cost of goods sold}} \times 365 \text{ days}$

2. **Collection period of trade debts** = $\dfrac{\text{Trade debtors}}{\text{Credit sales}} \times 365 \text{ days}$

It shows the approximate time (days) required to collect the outstanding trade debts.

3. **Payment period of trade credits** = $\dfrac{\text{Trade creditors}}{\text{Cost of sales}} \times 365 \text{ days}$

It shows the approximate time (days) required to pay the outstanding trade credits.

6.6 Solvency ratios – These ratios reflect the long-term ability of the company to generate cash internally or from external sources in order to meet long-term financial obligations like payment long-term loans or bonds. The ratios comprise:

1. **Gearing ratio or Debt/equity ratio** = $\dfrac{\text{Total long-term debt}}{\text{Equity}}$

If a business contracts high debt financing and the management does not use the loan judiciously, the risk of default of interest and debt repayments is high. The higher the ratio, the more risky the business is.

2. **Debt capitalization ratio** = $\dfrac{\text{Total long-term debt}}{\text{Total long-term debt + Equity}}$

It is a variant of gearing ratio but long-term debt assumes the status of equity. It is interpreted the same way as the gearing ratio.

3. **Interest cover ratio** = $\dfrac{\text{Profit before interest and tax}}{\text{Interest expenses}}$

It shows the number of times the interest expenses is covered by profit before interest and tax. Interest coverage of **3** and above is considered good because empirical evidence supports that firms having Interest coverage of 3 do not file bankruptcy petition.

6.7 Usefulness of Ratio Analysis

1. Ratios can be used to summarize the relationships and results that are significant to performance appraisal of a business entity.
2. Ratios are useful for the purpose of comparing performance of a company from year to year or with performance of other companies in the same industry.
3. A systematic collection of ratios allows trends to emerge.
4. Ratios can assist in predicting the future.

6.8 Limitations of Ratio Analysis

1. Ratios are not sufficient to provide a round picture of a business performance.

2. No inference could be drawn in the absence of a benchmark ratio.
3. Meaningful inferences can only be drawn by comparing ratios of firms with those of similar firms.
4. Consistency should be maintained in selecting the numerator and the denominator.
5. Ratio refers to past events which make it a mere guide in predicting the future.
6. Meaningful results will be obtained only if the performance is analyzed over a sufficiently long period of time.

6.9 ILLUSTRATION

Income statement and statement of financial position of **Gamma Enterprise** are shown below:

Trading, profit and loss account for the period ended 31st December, 2017

	N'000	**N'000**	**N'000**
Sales			64,000
Less Sales return			1,700
Net sales			**62,300**
Opening stock	12,480		
Add Purchases	37,600		
Add Carriage inward	1,500	51,580	
Less Purchases returns	4,600		
Less Closing stock	7,400	12,000	
		39,580	
Add Wages		2,000	
Cost of goods sold			(41,580)
Gross profit			**20,720**
Add discount received			300
			21,020
Less expenses:			
Transport & travelling expenses		4,000	
Discount allowed		280	
Carriage outward		2,500	
Salaries		3,000	9,780
Net profit/Profit before Interest and Tax (PBIT)			**11,240**
Less Interest expenses			200
Profit before tax (PBT)			**11,040**
Less Provision for tax			500
Profit after tax (PAT)			**10,540**

Statement of financial position as at 31st December, 2017

	N'000	**N'000**	**N'000**
Non-current assets:			
Building			10,000
Motor vehicle			8,000
Office equipment			4,000
Furniture			2,000
Total non-current assets			**24,000**
Current assets			
Stock	7,400		
Debtor	12,260		

Prepayment	500		
Cash in bank	500		
Cash in hand	200		
Total current assets		**20,860**	
Less Current liabilities:			
Accrued expenses	520		
Creditors	4,000		
Total current liabilities		**4,520**	
Net current assets			16,340
Net assets			**40,340**
Financed by:			
Capital (Equity)			**24,800**
Add Net Profit			10,540
			35340
Less Drawings			5,000
Net Equity			**30,340**
Long term debt			**10,000**
			40,340

Required: (a) Compute and comment briefly on the following: (i) Profitability ratios (Industrial average: Gross profit margin = 30%, Net profit margin = 25%, ROE = 35%, ROA = 35%, ROCE = 35%). (ii) Asset utilization ratios (Industrial average: 5times for all) (iii) Liquidity ratios (Industrial average: Current ratio = 3:1, Quick ratio = 1:1, Cash ratio = 0.5:1,). (iv) Activity ratios (Industrial average: Days inventory outstanding = 60 days, Debtors collection period = 30 days, Creditors payment period = 60 days) (v) Solvency ratios (Industrial average: Gearing ratio = 0.5, Debt capitalization ratio = 0.5, Interest coverage ratio = 20 times)

SOLUTION

(i) Profitability ratios

Operating profitability ratios:

1. **Gross profit margin** = $\frac{\text{Gross profit}}{\text{Sales}}$ X 100% = $\frac{20,720}{62,300}$ X 100 % = 33.26%

2. **Net profit margin** = $\frac{\text{Net profit}}{\text{Sales}}$ X 100% = $\frac{11,240}{62,300}$ X 100% = 18.04%

Return on investment ratios:

3. **Return on equity** = $\frac{\text{Profit after tax}}{\text{Equity}}$ X 100% = $\frac{10,540}{10,340}$ X 100% = 101.93%

4. **Return on assets** = $\frac{\text{Profit before interest and tax}}{\text{Total assets}}$ X 100% = $\frac{11,240}{44,860}$ X 100% = 25.02%

5. **Return on capital employed** = $\frac{\text{PBIT}}{\text{Equity + Long term debt}}$ X 100% = $\frac{11,240}{10,340 + 10,000}$ X 100% = 55.26%

(ii) Assets utilization ratios

1. **Total assets turnover** = $\frac{\text{Sales}}{\text{Total assets}}$ = $\frac{62,300}{44,860}$ = 1.39 times

2. **Non-current assets turnover** = $\frac{\text{Sales}}{\text{Non-current assets}} = \frac{62,300}{20,860}$ = 2.99 times

3. **Inventory turnover** = $\frac{\text{Cost of sales}}{\text{Inventory}} = \frac{20,720}{1/2(12,480 + 7,400)}$ = 2.08 times

4. **Debtors turnover** = $\frac{\text{Credit sales}}{\text{Debtors}} = \frac{62,300}{12,260}$ = 5.08 times

(iii) Liquidity ratios

1. **Current ratio** = $\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{20860}{4,520}$ = 4.61:1
2. **Quick ratio or Acid test ratio** = $\frac{\text{Current assets – Stocks – Prepayment}}{\text{Current liabilities}} = \frac{13410}{4,520}$ = 2.97:1
3. **Cash ratio** = $\frac{\text{Cash}}{\text{Current liabilities}} = \frac{200}{4,520}$ = 0.08:1

(iv) Activity ratios

1. **Average stock turnover** = $\frac{\text{Cost of goods sold}}{\text{Average stock}} = \frac{41,580}{1/2(12,480 + 7,400)}$ = 4.18 times

= 365/4.18 = 88 days.

OR

Days inventory outstanding = $\frac{\text{Average stock}}{\text{Cost of goods sold}}$ X 365 days = $\frac{1/2(12,480 + 7,400)}{41,580}$ X 365

= 88 days

2. **Collection period of trade debts** = $\frac{\text{Trade debtors}}{\text{Credit sales}}$ X 365 days = $\frac{12,260}{46,725}$ X 365 = 96days
3. **Payment period of trade credits** = $\frac{\text{Trade creditors}}{\text{Cost of sales}}$ X 365 days = $\frac{4,000}{41,580}$ X 365 = 35 days

(v) Solvency ratios

1. **Gearing ratio or Debt/equity ratio** = $\frac{\text{Total long-term debt}}{\text{Equity}} = \frac{10,000}{30,340}$ = 0.39 times

2. **Debt capitalization ratio** = $\frac{\text{Total long-term debt}}{\text{Total long-term debt + Equity}} = \frac{10,000}{40,340}$ = 0.28 times

3. **Interest cover ratio** = $\frac{\text{Profit before interest and tax}}{\text{Interest expenses}} = \frac{11,240}{200}$ = 56.2 times

Post Test

Below are the income statement and statement of financial positions of Helen Shopping Mall for the year ended 31st December, 2018:

Helen Shopping Mall

Income statement for the year ended 31st December, 2018

	2018	**2017**
	N’000	**N’000**

Sales	450,000	720,000
Cost of goods sold	(300,000)	(320,000)
Gross profit	150,000	400,000
Distribution expenses	(20,000)	(40,000)
Marketing expenses	(20,000)	(40,000)
Administrative expenses	(30,000)	(80,000)
Net profit/Profit before Interest and Tax (PBIT)	(80,000)	(240,000)
Interest expenses	(20,000)	(24,000)
Profit before tax (PBT)	60,000	216,000
Tax	(5,000)	(36,000)
Profit after tax (PAT)	55,000	180,000

Helen Shopping Mall
Statement of financial position as at 31st December, 2018

	2018	**2017**
	N'000	**N'000**
Non-current assets	150,000	120,000
Current assets	35,000	30,000
Current liabilities	30,000	10,000
Net current assets	5,000	20,000
Net assets	155,000	140,000
Financed by:		
Capital	100,000	40,000
Retained Profit	15,000	20,000
Net Equity	115,000	60,000
10% Debenture	40,000	80,000
	155,000	140,000

Additional information:

i. Debtors is 20% of current liabilities
ii. Credit sales is 75% of total sales

Required

a. Compute the following financial ratios for the year ended 31st December, 2018 and the corresponding period (2017):

(i) Net profit margin (ii) Current ratio (iii) Interest coverage ratio (iv) Debtors' collection period

(v) Non-current asset turnover

b. Comment briefly on each set of ratios computed, given the following industrial averages: (i) Net profit margin = 25% (ii) Current ratio = 2:1 (iii) Interest coverage ratio = 5 times (iv) Debtors' collection period = 15 days (v) Non-current asset turnover = 5 times.

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LECTURE SEVEN

PHILOSOPHY OF ETHICS AND ETHICAL THEORIES

7.0 Introduction

Ethics is about morality, and acting in a way that is morally justified. Most individuals develop a sense of morality, and act in accordance with what they consider 'right' and 'wrong'. However, opinions about what is 'right' and 'wrong' can differ enormously. An accountant needs to be aware of various forms of ethics including personal ethics, professional ethics and business ethics. However, moral philosophers do not agree on the nature of morality. Two opposing views are 'absolutism' and 'relativism'. These opposing views will be discussed in this lecture. The absolutist and relativist views of ethics are concerned with moral reasoning and ethical opinions. These views lead on to the question of how should individuals apply their moral judgements in making decisions and taking action. Two differing approaches to ethical decisions namely; deontological approach and teleological approach (also called the consequentialist approach) will be equally addressed in this lecture.

Objectives

At the end of this lecture, students should have a good understanding of:-

a. Ethics and ethical dilemma
b. Importance of accounting ethics
c. Nature of morality
d. Approaches to ethical decision

Pre-Test

1. What is ethics?
2. What is ethical dilemma?

CONTENT

7.1 Definitions

Personal ethics

Personal ethics describes the intrinsic moral principles and values that govern an individual's interactions with others. Personal ethics is neither enforced nor required by a prescriptive code – it reflects one's inner views on morality and right and wrong. Personal ethics are typically influenced by people's family, friends, experiences, culture and religion.

Professional Ethics

Professional ethics describes the moral principles and values that govern behaviour in the context of a particular profession such as lawyers, doctors, architects and accountants. Professional ethics are normally specified in a professional code of conduct that all members (and students) professing to be part of that profession must abide by. Adherence to an institute's professional code of conduct such as ICAN's Code of Professional Conduct is normally a requirement of membership and remains relevant throughout the professional's life, not just in the work environment.

Business Ethics

Business ethics describes the moral principles and values that guide how people and institutions behave in the world of commerce. Business ethics considers how the pursuit of self-interest (e.g. profits) impacts others through the actions of individuals or firms within business. Some businesses (particularly large multinationals) develop a formal corporate code of ethics that provides a reference point for employees' and other stakeholders' behaviour. A business code of ethics will apply to all employees whether they are members of a professional body or not.

7.2 Moral philosophy

Moral philosophy is concerned with explaining the nature of ethics and morality. It is also concerned with providing a moral justification for actions that are taken by individuals and organizations.

7.3 Ethical dilemma

An ethical dilemma involves a conflict between two moral principles whereby it can be argued that both perspectives are fair and reasonable. Ethical dilemmas typically arise in situations whereby a particular action is likely to benefit one stakeholder whilst harming another. It is a situation where guiding moral principles cannot unequivocally resolve the conflict and determine which course of action is right or wrong. In practice, there are often pressures on an individual at work to 'bend the rules' and act in a way that is not ethical. Unethical behaviour might be illegal, but it is often 'legal but immoral'. Pressures to act unethically can create a moral dilemma – what is the right thing to do?

Sometimes it is not clear what the right course of action should be. When an individual thinks that something might be 'wrong', he could be faced with a decision about what to do. Making a moral or ethical decision might not be easy, especially when colleagues or bosses do not agree with you and will not listen to what you have to say. Some individuals might take the view that when they are at work, they act according to a different set of rules and with a different moral outlook, compared to the way they think and behave in their private life. This view can be used to justify decisions or actions at work that are unethical, on the grounds that 'business is different'.

However, this is not a view that accountants should take because accountants (including both students and qualified accountants) are bound by professional codes of conduct such as the ICAN Code of Professional Conduct at all times, not just in the work environment. In complying with codes of professional ethics accountants should be prepared to make difficult choices when faced with an ethical dilemma.

7.4 Acting in an ethical way: moral philosophy

As an accountant, you need to recognize the need to behave in an ethical way. If you do not intend to act ethically in your work, you do not deserve to be an accountant! To understand how to act ethically, it is necessary to have some understanding of ethics, how ethical codes of behaviour are established and maintained. It is also useful to recognize a link between ethical behaviour and good corporate governance. Good corporate governance is associated with integrity, honesty and transparency. These are ethical qualities in business. It is also important to recognize that individuals and businesses have differing views about 'right' and 'wrong'. We might think that we know what is right, but others might disagree strongly. Differences in ethical views can be very large between different communities and cultures. There is general agreement that some actions are 'wrong' and unethical. It is wrong to steal and wrong to commit murder.

- Many individuals take the view that war is 'wrong', but others might think that war is sometimes necessary to achieve a desirable and morally worthwhile objective.
- There are strong differences of opinion on difficult moral issues such as abortion, euthanasia and medical research on animals.
- There are probably strong differences on opinion on many other issues. Is it wrong for a government to torture a 'terrorist' in order to obtain information that might reduce the risk of

more terrorist attacks and deaths of civilians? Is it wrong to tell a lie to your boss at work in order to protect a colleague from dismissal for a minor disciplinary offence?

7.5 Importance of Ethic Education to Accountants

The study of ethics is important to accountants due to the following reasons:

- Accountants must ***abide by professional codes of ethics*** due to membership of a professional accountancy body.
- It is in the public interest that ***members of the public have confidence*** in the accountancy profession. This is necessary to help facilitate commerce and industry, promote growth and prosperity and to help sustain a reliable and trustworthy economic mechanism.
- Accountants must continue to be seen as ethical and independent for their ***opinion*** to be valued both within audit and advisory roles.
- The study of ethics will help promote ***consistency in the ethical values and principles*** that can be expected of accountants.
- Adherence to professional codes of ethics remains ever critical in protecting the ***reputation*** of the accountancy profession in light of corporate scandals (such as Enron and WorldCom) and the global financial crisis.

7.6 Ethical Theory of Absolutism

The ethical theory of absolutism, or moral absolutism, is that ***there are absolute moral standards against which the morality of actions can be judged.*** 'Right' and 'wrong' are recognized by objective standards that apply universally, to everyone. Plato was a philosopher who argued in favour of moral absolutism and in 'good' that always holds its value. Absolutism might be associated with religious morality, but an individual can have an absolutist view of morality without being religious. For example, an individual might believe that slavery, war, child abuse and the death penalty are all morally wrong and cannot be justified under any circumstances.

Other terms related to ethical absolutism include:

Ethical universalism which describes the situation whereby all of mankind accept and live by the same basic ethical standards regardless of culture, race or religion

Ethical objectivism which describes the view that what is right or wrong doesn't depend on what anyone thinks is right or wrong but rather the pure facts irrespective of scenario.

7.7 **Ethical Theory of Relativism**

The ethical theory of relativism rejects the absolutist view. It states that *there is no objective or absolute moral truth, and there are no universal standards of moral behaviour.* There are two aspects to relativism:

Descriptive ethical relativism*:* This is the view that *different cultures and societies have different ethical systems and cultures.* 'Right' and 'wrong' are concepts that relate to the particular culture. There is no universal rule about right and wrong.

Normative ethical relativism: *The beliefs or moral values within each culture are right within that culture.* It is impossible to judge the values of another culture externally or objectively. Moral values of a culture can only be judged from within the culture.

Religious relativism is an example of normative ethical relativism and maintains that *one religion can be true for one person or culture but not for another.* No single religion, therefore, is universally or exclusively true.

Historical relativism is another example of normative ethical relativism and provides context for ***ethical views to vary over periods of time.*** For example the elimination of suspected witches or the widespread adoption of slavery in the past may not be acceptable in today's society. Similarly trends may move in the opposite direction – for example the liberalization of clothing fashions or the changing role of women in society. Relativism accepts that ethical behaviour cannot be judged objectively. What is right and what is wrong can also vary according to circumstances.

7.8 Deontological Approach to Ethical Decisions

A deontological approach to ethical decisions is based on an absolutist view of ethics. This approach is closely associated with the 18th Century German philosopher, Kant. Deontology is a belief in a sense of duty. *It is based on the view that there are universal moral laws, and individuals have a duty to obey them, in all the actions that they take and irrespective of what the consequences might be. These universal laws or principles are binding on everyone. The absolute set of moral standards applies to us all.* Actions are right or wrong in themselves, and there should be no regard for the consequences. For example, it is always wrong for a government to torture a captured terrorist in order to obtain information, even if the consequence might be that there will be more terrorist attacks and more deaths of civilians.

Kant argued that an action is morally right only if the person taking the action is motivated by 'good will'. In other words, an action is morally right only if it is done from a sense of duty and for reasons of principle. He developed the concept of the categorical imperative. He argued that we can judge whether an action is morally right by asking whether it would be consistent with the categorical imperative. The categorical imperative can be expressed as follows:

□□Act so that you can want the principle for your action to become a universal law: At a simple level, this means judging whether an action is moral by asking what would happen if everyone behaved in exactly the same way.

□□Act so that you treat other people as an end in themselves, never as a means to an end

7.9 Teleological Approach (Consequentialist Approach) to Ethical Decision

The teleological approach, also called the consequentialist approach, to moral action is *based on the relativist view of ethics.* This approach *takes the view that the morality of an action should be judged by its consequences. If the consequences are 'good', the act is morally correct. 'The end justifies the means.'*

An example of the teleological approach is **utilitarianism**. This is a view of morality most closely associated with the 19th Century British philosopher John Stuart Mill. Mill argued that *an act is 'right' if it brings the greatest amount of good to the greatest number of people.*

The teleological approach to ethical decisions can therefore be explained as follows:

(1) Actions in themselves do not have an intrinsic moral value.

(2) The moral value of an action is determined by its consequences (not the act itself).

(3) Using reason, it is possible to calculate the costs and the benefits of an action, to determine whether or not it is morally correct. Taking this approach, for example, it would be argued that telling a lie can be justified and would normally be acceptable provided that the consequences are 'good' or 'benevolent'.

Post-Test

THEORY

1. What is Ethics? Enumerate 5 importance of accounting ethics education.
2. What is Ethical Dilemma? Differentiate between absolutism and relativism theories of ethics.
3. Differentiate between deontological and teleological approaches to ethical decision making.

MCQ

1. ………………….. describes the moral principles and values that guide how people and institutions behave in the world of commerce. A. Personal Ethics B. Business Ethics C. Professional Ethics D. Moral Philosophy

2. ………… involves a conflict between two moral principles whereby it can be argued that both perspectives are fair and reasonable. A. Personal Ethics B. Business Ethics C. Moral Philosophy D. Ethical Dilemma

3. ………….. is of the view that different cultures and societies have different ethical systems and cultures. A. Ethical Universalism B. Descriptive Ethical Relativism C. Normative Ethical Relativism D. Historical Relativism

4. ………….. posits that an act is 'right' if it brings the greatest amount of good to the greatest number of people. A. Universalism B. Relativism C. Utilitarianism D. Absolutism

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LECTURE EIGHT
ETHICS, CULTURE AND CORPORATE SOCIAL RESPONSIBILITY
8.0 Introduction
Culture has been defined as the 'shared beliefs, attitudes, norms, values and behaviour found among speakers of one language in one time period and in one geographical region.' This definition suggests that in order to share a common culture, people must speak a common language and live in the same geographical area. Culture might also change over time. Companies and other entities also develop their own culture. The individuals who work in a company often develop cultural attitudes and habits that are unique to that company. Even global companies, in which employees do not share the same language or live in the same geographical area, can develop a culture of shared beliefs and attitudes. There is a link between culture and ethics, because the culture in which people live shapes their ethical beliefs, attitudes and values.

Objectives
At the end of this lecture, students should have a good understanding of:-
1. Corporate social responsibility
2. The relationship between ethics and corporate culture through Johnson and Scholes
3. Cultural Web and Edgar Schein's Three Levels of Culture Models

Pre-Test
1. What is culture?
2. What is ethics?
3. What is corporate social responsibility?

CONTENT
8.1 Culture, Ethics and Corporate Social Responsibility
Corporate social responsibility (CSR) is concerned with issues such as the interests and welfare of employees, customers, communities in which the company operates, the general public, and society as a whole. Well-governed companies take a stand against crime and do not sanction criminal activities by their employees, in any country in which they operate. In recent years, there has been much greater awareness of environmental issues. The role of companies in damaging and protecting the environment to create sustainable businesses is being discussed in public domain. Attitudes to CSR are evident in the ethical stance that many companies now take on these issues, and ethical stance in turn is affected by the corporate culture.

8.2 Johnson and Scholes' Cultural Web
Johnson and Scholes suggested that there is a cultural web within any organization, which affects the way in which individuals understand the organization in which they work. *This understanding of their organization called their 'paradigm' of the organization.* Employees find it difficult to think and act outside this paradigm. The cultural web consists of *six inter-related elements of culture* within an organization.
- **Routines and rituals**. Routines and rituals are 'the ways things are done around here'. Individuals get used to established ways of doing things.
- **Stories and myths**. Stories and myths are used to describe the history of an organization, and to suggest the importance of certain individuals or events. They are passed by word of mouth. They help to create an impression of how the organization got to where it is, and it can be difficult to challenge established myths and consider a need for a change of direction in the future.

- **Symbols**. Symbols can become a representation of the nature of the organization. Examples of symbols might be a company car or helicopter, an office or building, a logo or a style of language.
- **Power structure**. Organizations are influenced by the individuals who are in a position of power. In many business organizations, power is obtained from management position. However, power can also come from personal influence, or experience and expertise.
- **Organization structure**. The culture of an organization is affected by its organization and management structure. Hierarchical and bureaucratic organizations might find it particularly difficult to adapt to change and are often conservative in their outlook.
- **Control systems**. Performance measurement and reward systems within an organization establish the views about what is important and what is not so important. Individuals will focus on performance that earns rewards. For example, it has been suggested that cash bonus systems help to create the profit-driven culture in investment banks. The cultural web within a company shapes its corporate ethics.

8.3 Edgar Schein's Three Levels of Culture

Schein had similar views about corporate culture. He suggested that employees working within a company have shared values, beliefs and ways of thinking. These interact with the policies, organization structure and politics of the company's management system to create a corporate culture. Schein also argued that organization culture is strong because it is regarded as something that helps the company to succeed. *An organization culture is a set of assumptions that a group of people working together have invented or discovered by learning how to deal with problems that the organization faces, internally and in its external environment*. These assumptions work well enough to be considered valid. They are therefore 'taught' to individuals who join the organization. New entrants therefore learn the culture of the organization and become a part of that culture. According to Schein, there are *three levels of culture that members of an organization acquire*:

- **The outer skin**. *At this level, the culture of a company is evident in what an observer can see by visiting the company, and in the values that it states.* The facilities and surroundings in which employees work help to create culture. So too does the way that employees dress. Culture is also seen in the way that employees talk to each other and interact with each other. A company might have a formal code of ethical behaviour, which is intended to shape the attitudes of all its members. However, stated values and mission statements are often expressed in general terms, such as 'providing a service to the community' and 'providing the best quality of service to customers'.
- **An inner layer**. At this second level, the employees in a company share common views on specific issues. *This layer of culture can be seen in the ethical stance that the company takes.* Whereas the outer layer of culture is expressed in general terms, this inner layer is expressed in relation to specific issues, such as:
- Should we trade with companies or governments in politically repressive countries?
- Should we buy goods from suppliers who use slave labour or child labour?
- **The heart**. The third level of culture is the company's **paradigm**. This is a term for the shared assumptions and attitudes about what really matters, that are taken for granted and rarely discussed. These affect the way that the organization sees itself and the environment in which it operates, and is the real 'core' culture of the organization. Unlike mission statements and codes of ethics, a paradigm is not written down, and it is difficult to identify or explain. The 'paradigm' has also been described as the reason why the organization exists. A police force exists to catch criminals, and a school exists as a place for learning. Schein argued that changing corporate culture is very difficult. The 'outer skin' can be changed fairly easily, with a determined effort by management, but it is very difficult to change the paradigm. The

following example suggests that codes of corporate ethics cannot be made to work unless senior management enforces them and ensures that they are applied. The example can also be used as an illustration of how it is much more difficult to alter the paradigm of a company than the ‘outer skin’ of its culture.

8.4 Culture, ethics and global companies

Global companies operate in many different countries and employ managers and other employees from diverse cultures. It can be difficult for global companies to develop a single corporate culture. It is therefore difficult for the senior management of global companies to ‘enforce’ their view of business ethics on the entire organization.

Post-Test

1. Johnson and Scholes suggested that there is a cultural web within any organization, which affects the way in which individuals understand the organization in which they work. This understanding of their organization called their ‘paradigm’ of the organization. Employees find it difficult to think and act outside this paradigm. The cultural web consists of six inter-related elements of culture within an organization. **Required:** List and discuss the six inter-related elements of culture within an organization.
2. Schein suggested that employees working within a company have shared values, beliefs and ways of thinking. These interact with the policies, organization structure and politics of the company’s management system to create a corporate culture. Schein also argued that organization culture is strong because it is regarded as something that helps the company to succeed. According to Schein, there are three levels of culture that members of an organization acquire. Required: Outline and discuss the three levels of culture that members of an organization acquire.

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LECTURE NINE

PROFESSIONAL PRACTICE AND CODES OF ETHICS

9.0 Introduction

The word 'professional' is associated with a highly-qualified group of individuals who carry out a particular type of highly-skilled work. Examples of professions are doctors and surgeons, dentists, lawyers, actuaries and accountants. Each professional group is organized and regulated by a professional body. (In the UK for example, the professional bodies often have a royal charter. The accountancy profession has several different professional bodies.) The professional body has the power to:

- admit new members to the profession
- award qualifications to individuals who achieve a required standard of skill or competence
- expel members from the profession, for unprofessional conduct

It is often a legal requirement that certain aspects of the work of professionals must be performed by professionally-qualified people.

Objectives - At the end of the lecture, the student should be able to have a good understanding of:

1. What a profession is.
2. The relationship between a professional and his clients
3. Influence of accounting profession in business and government

Pre Test

3. What is a profession?
4. List some codes of ethics of professional accountants?

CONTENTS

9.1 Professionals and their Clients

The relationship between professionals and their clients is based on several perceptions of the nature of a professional person.

- There is a *relationship of trust*. The client can trust the professional to act in a proper way, in accordance with a professional code of conduct. In return, the professional expects the client to place its trust in him (and her). For example, a client should not withhold relevant information from a professional that would affect his decisions or judgements.
- There is an assurance that the professional has attained a minimum level of *expertise and competence.* This assurance is provided, in accountancy, by the requirements to

(1) Pass formal examinations in order to obtain a qualification,

(2) Have relevant work experience and

(3) Continue with professional development and training throughout the accountant's professional career.

- There is also an implication in the professional-client relationship that the professional has more concern for the client than for his own self-interest. *The professional puts the client before himself.*

9.2 Acting Professionally

Professionals are expected to act in a professional way. Professional behavior means complying with relevant laws and obligations, including compliance with the code of conduct (including the code of ethics) of the relevant professional body.

Professional behaviour is commonly associated with:

- acting with integrity, and being honest and straight-dealing

- providing objective opinions and advice, free from bias, influence or conflicts of interest
- using specialist knowledge and skill at an appropriate level for the work
- confidentiality: respecting the confidentiality of information provided by clients
- avoiding any action that brings the reputation of the profession into disrepute
- compliance with all relevant laws and regulations

The ICAN Code of Conduct states that 'the principle of professional behavior imposes an obligation on Chartered Accountants to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession.'

9.3 Acting in the Public Interest

An aspect of professional bodies, which separates a profession from a trade, is that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession *'not to act exclusively to satisfy the needs of a particular client or employer'.*

When the demands or needs of a client or employer appear to be contrary to the public interest, accountants should consider the public interest. So what is the public interest? Professional codes of ethics do not provide a clear definition, but it is usual to associate the public interest with matters such as:

- detecting and reporting any serious misdemeanor or crime
- protecting health and public safety
- preventing the public from being misled by a statement or action by an individual or an organization
- exposing the misuse of public funds and corruption in government
- revealing the existence of any conflict of interests of those individuals who are in a position of power or influence

9.4 Influence of the Accounting Profession in Business and Government

A function of the accounting profession is to record financial transactions and to report the financial performance and financial position of business entities and government organizations. Information about business and other organizations comes largely from accountants. Arguably, accountancy has an influence on business and government that is both continuous and more extensive than any other profession.

Financial reporting

Accountants are involved in the preparation of financial statements, which are used by shareholders and other investors to assess companies and make their investment decisions. Financial reports are often used to prepare information about companies for other interested parties, such as the government (for tax purposes) and employees.

Auditing

Accountants also check the financial statements of companies (and government organizations), and report on their 'accuracy' to shareholders or government. Shareholders rely on the opinion of the auditors to obtain reassurance that the financial statements give a true and fair view. The need by investors for reliable financial reporting and auditing was discussed in an earlier chapter, in the context of corporate governance.

Management accounting

Management accountants provide information to management, to assist managers with decision-making. In many organizations, management accountants have extended their involvement with management information systems to the provision of strategic as well as shorter-term management information, and non-financial as well as financial information.

Tax
As tax advisers, accountants can help corporate clients to avoid payment of tax through tax avoidance schemes. A criticism of tax avoidance schemes is that they enable wealthy individuals and profitable companies to avoid paying tax, which means that the tax burden is shared by the poorer members of society.

Consultancy
Accountancy firms may provide consultancy services to a range of different clients. Major strategic decisions by government and companies might be influenced by the advice and recommendations from consultants. In the UK for example, the major accountancy firms have been involved in providing advice to the government on the privatization of public services and the introduction of private capital into financing public investments.

Public sector accounting
Accountants within the public sector are responsible for recording financial transactions within government departments and government-owned organizations, and for financial reporting and auditing within the government sector.

9.5 Public Expectations of the Accountancy Profession
The general public has high expectations of the accountancy profession.

- Many non-accountants do not have much understanding of accounting issues, but they rely on accountants to ensure that financial reporting is reliable and 'fair', and that management is not 'cheating' by presenting misleading and inaccurate figures in their accounts.
- Auditors are also seen, by many members of the public (rightly or wrongly), as a safeguard against fraud.
- The public continues to believe that the accountancy profession is an ethical profession that offers some protection to society against the 'excesses' of capitalism.

A role of the accountancy bodies should be to reinforce this public perception of an ethical profession. They do this by issuing codes of conduct, including codes of ethics, and expecting all their members to comply.

9.6 Accountants acting against the public interest
Accountants may be rule-followers. Technical rules are provided by financial reporting standards and other reporting regulations. A function of the professional accountancy bodies is to provide rules of conduct and ethical behaviour, with the expectation that all members should follow the rules. Accountants might not be moral by nature, but they can be taught to think and act ethically.
Occasional problems will inevitably arise when some accountants choose a different set of rules, or deliberately break the rules. The consequences depend on the nature of the rule-breaking. In an extreme case such as Enron, breaking the rules by accountants contributed significantly to the collapse of the company. Even in the Enron case, the accountants who were prosecuted and imprisoned did not necessarily understand what they had done wrong. They were simply doing the same as other people, and adopting the culture of the company.
Alvesson and Willmott (1996) have argued that employees come into a company bringing a notion of fairness and justice with them, which they expect to see within the company. However, different people have different views of right and wrong. Fairness and justice are abstract concepts and values that mean different things to different employees and in different work situations. This is how different cultures (and different sets of rules) arise. So how do

companies and accountancy firms apply ethical rules of conduct? One approach is to develop and implement business codes or professional codes of ethics. If forcefully applied, these can help to create a better understanding by accountants of what is right and wrong, how to identify moral dilemmas, and how to act whenever an ethical problem arises.

Post Test

1. An aspect of professional bodies, which separates a profession from a trade, is that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession 'not to act exclusively to satisfy the needs of a particular client or employer'. Required: (a) List 5 ways through which accountants can display professional behavior? (b) Mention 5 roles of accountants in protecting public interest?

2. A function of the accounting profession is to record financial transactions and to report the financial performance and financial position of business entities and government organizations. Information about business and other organizations comes largely from accountants. Arguably, accountancy has an influence on business and government that is both continuous and more extensive than any other profession. Discuss?

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LECTURE TEN

CODES OF ETHICS FOR ACCOUNTANTS

10.0 Introduction

Every professional accountancy body has issued a code of conduct and code of ethics for its members and student members. Even when an individual works for a company or a firm of accountants that has its own code of ethics, there is a need for a professional code of conduct. This is because accountants have a professional *duty to act in the public interest*, and this aspect of professional behaviour is not covered by corporate ethical codes. Although each professional accountancy body has its own code of ethics, all codes are similar, because they are based on the International Federation of Accountants (IFAC) Code. This Code is issued by the Ethics Committee of IFAC, whose members include the professional accountancy bodies of most countries.

Objectives

At the end of this lecture, students should have a good understanding of:-

g) Rule-based and principle-based codes of ethics
h) IFRS and its implications on financial reporting
i) Contents of financial statements

Pre-Test

5. What is ethics?
6. Differentiate between corporate ethics professional ethics?

CONTENT

10.1 Types of Ethical Codes

1. ***Rule-based Ethical Codes***

Regulatory body may issue a code of ethics for accountants that contain specific rules about how they should act in specific situations. This is a rule-based code of ethics. Rule-based codes have several weaknesses which include:

- It is not possible to make rules that can take care of different situations that an accountant might face where an ethical decision must be made.
- It might be necessary to review and update the rule book regularly because the type of situations that an accountant might face could change, as the business environment changes.
- A rule book cannot easily make allowances for national and cultural differences in ethical viewpoint. Ethical views differ between countries and cultures. Behaviour that might be considered slightly unethical in one country might be perfectly normal and acceptable in another country.

2. ***Principle-based Ethical Codes***

A principle-based code of ethics for accountants is a code that specifies general principles of ethical behaviour, and requires the professional accountant to act in accordance with the principles. The accountant is required to use judgement in deciding whether in each case a particular course of action is a 'proper' or 'ethical' one.

ICAN's Professional Code of Conduct and Guide for Members

ICAN's 'Professional Code of Conduct and Guide for Members' is the code of ethics applicable to members and students of ICAN. The Code contains similar provisions to the IFAC Code of Ethics for Professional Accountants. For example:

- Both codes are principle-based;
- Both codes are based on the same five fundamental ethical principles;

Both codes advocate a system of identifying threats to the fundamental ethical principles and responding to those threats with safeguards;
Both codes include guidance for Professional Accountants in Public Practice; and Professional Accountants in Business

10.2 Fundamental Ethical Principles
Professional accountants are required to comply with the following fundamental ethical principles:
- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behavior

1. ***Integrity***

An accountant must be honest and straightforward in his professional and business dealings. This includes a requirement for 'fair dealing' and a requirement to be truthful. For accountants in public practice, 'integrity' is often associated with independence of mind and judgement.
For accountants in business, however, the concept of independence is not relevant in the same way as it is for independent auditors. This is because accountants in business are simply not independent due to the fact they are employees and frequently shareholders or recipients of other benefits such as healthcare and pension contributions. All this mean that employed accountants in business have significant self-interest in their employment and are therefore not independent.
However, accountants in business should still try to apply the principle of objectivity in all the work that they do with the aim of being balanced, fair and unbiased. For accountants in business, the concept of integrity also means observing the terms of his or her employment, but avoiding involvement in any activity that is illegal. If asked or encouraged to become involved in unlawful activity, the accountant must decline.

2. ***Objectivity***

An accountant must not allow his professional or business judgement to be affected by bias, conflicts of interest or undue influence from others. For accountants in business, this includes undue pressure from the employer. A very important aspect of integrity is that an accountant should not be associated with reports or any other provision of information where he or she believes that:
- the information contains a *materially* false or misleading statement
- the information contains a statement that has been prepared and provided recklessly, without proper care or consideration for its accuracy
- there are omissions or the information is presented in a way that makes the relevant information difficult to see, with the effect that the information could be seriously misleading.

3. ***Professional competence and due care***

An accountant has a duty to maintain his professional knowledge and skills at a level that enables him to provide a competent professional service to his clients or employer. This includes a requirement to keep up to date with developments in areas of accounting that are relevant to the work that he does. Accountants should also act diligently in accordance with relevant technical and professional standards when doing their work for clients or employer.

Technical and professional standards include:

- Standards issued by IFAC (such as International Standards on Auditing) or a similar national regulatory body
- Financial reporting standards (IFRSs)
- Standards and regulations of the member's professional accountancy body
- Relevant legislations

Professional accountants have a duty to carry out the instructions of an employer or client with due care and skill, insofar as these are compatible with the ethical requirements for integrity, objectivity and independence.

4. ***Confidentiality***

Accountants must respect the confidentiality of information obtained in the course of their work. This applies to the confidentiality of information within the firm or employer's organization, as well as to confidentiality of information about clients. The requirement to keep information confidential applies:

- in a social environment as well as at work: for example, an accountant must be careful of what he says to a good friend who also happens to be a business associate, or to a wife or husband who is also a professional accountant
- after the accountant has moved to another job – confidentiality applies to information obtained when working for a former employer. In addition, confidential information must never be used to obtain a personal benefit or a benefit for a third party.
- accountants are not expected to disclose client information to the authorities where the work for the client is covered by legal professional privilege.

There are some circumstances when the disclosure of confidential information is permitted or even required by law.

- Confidential information about a client can be disclosed if the client has given permission. Before disclosing the information, however, the accountant should consider whether the disclosure might harm a third party.
- The law might also require the disclosure of confidential information to the appropriate authorities. For examples:
  - firms of accountants are expected to disclose suspicions of money laundering by a client to the appropriate authorities
  - tax evasion is a crime and accountants are required to report tax evasion by clients to the authorities
  - Disclosure is also permitted when the accountant has a professional right or duty, and disclosure is not prohibited by law.

5. ***Professional behaviour***

Accountants are required to observe relevant laws and regulations, and to avoid any actions that would discredit the accountancy profession.

Post-Test

1. Every professional accountancy body has issued a code of conduct and code of ethics for its members and student members. Even when an individual works for a company or a firm of accountants that has its own code of ethics, there is a need for a professional code of conduct. Required: Differentiate between rule-based codes and principle-based codes.
2. ICAN's 'Professional Code of Conduct and Guide for Members' is the code of ethics applicable to members and students of ICAN. The Code contains similar provisions to the IFAC Code of Ethics for Professional Accountants. Both codes are based on the

same five fundamental ethical principles. Required: List and explain the five fundamental ethical principles.

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LECTURE ELEVEN
ETHICAL DECISION MAKING MODELS
11.0 Introduction
Business entities and non-business entities are exposed to ethical risk. This is the risk that some of its managers or employees will act in a way that is unethical, and the entity will suffer some loss or harm as a consequence. There is a risk to the entity itself from deception or fraud by employees. In addition, there is a risk of unethical action by some individuals causing harm to others – customers, other employees, suppliers, the community, and so on. It might be argued that ethical risk can be minimized by recruiting and training individuals with strong moral character. Tucker's 5 question model for ethical decision-making in business will be discussed in the course of this lecture.

Objectives

At the end of this lecture, students should have a good understanding of:-

j) System Development Ethics
k) The purpose of ethical decision-making models
l) Tucker's 5 question model for ethical decision-making

Pre-Test

7. What is ethics?
8. Differentiate between codes of corporate ethics and codes of professional conduct?

CONTENT

11.1 System Development Ethics
System development ethics, however, is based on the view that recruiting and training morally-strong individuals is not sufficient. In order to act in a moral way, individuals need support from the systems they work in, and the environment provided by their employer. The employer should give clear guidance and moral support to its employees. 'Personal improvement and character-building can only occur in morally supportive environments that are rationally-planned and maintained.' Codes of corporate ethics and codes of professional conduct help to provide the environment that individuals need.

11.2 The purpose of ethical decision-making models
Guidance about ethical decision-making can also be provided by a decision making model. The purpose of an ethical decision-making model is to help individuals to assess, before they make a decision, whether the decision is ethically correct. These models do not deal with the problem of what is right or wrong. They assume that the basis for judging right and wrong is understood. This means that they could be used with either a deontological or a teleological approach to ethics, although a teleological approach is much more common in business. Several ethical decision-making models have been developed for use in a business context, and can also be applied to professional activities such as accounting.

11.3 Tucker's 5 question model
Tucker's 5 question model for ethical decision-making in business is based on the view that the profit motive is justified, and the purpose of decision-making in business should be to make a profit. However, profits should be made in an ethical way.

In order to be ethically correct, business decisions and actions should be legal. Activities outside the law by a business cannot be correct. Business should also be conducted in a fair way, without deception or other 'under-hand' acts. For example, competitors should be treated with respect, and customers and employees should be treated in a fair way. Tucker's

model is also based on the view that decisions should not be taken in business if they do not support sustainable business or could be damaging to the environment.
The 5 question model involves asking five questions before making a business decision. If the answer to all five questions is ‘Yes’, the decision is ethically sound. The five questions about a decision are:
(1) Is it profitable?
(2) Is it legal?
(3) Is it fair?
(4) Is it right?
(5) Is it sustainable or environmentally sound?

11.4 Case Study
An international company is planning to build a new manufacturing plant in a developing country. The country was chosen because costs of land and labour are cheap, so the forecast profits are high. The plant will be built on a ‘brown field’ site just outside the country’s capital city, which used to be the site of another factory that has now been closed down. The company intends to build a plant that will use modern technology that keeps environmental emissions at a low level.
The country’s government has approved the building of the new plant, and the local population is eagerly waiting for construction to begin, bringing with it much needed commercial activity – and jobs. The government believes that the plant will bring economic growth to the country’s economy. ***Required:*** Is the decision to build the plant an ethical one? Use the Tucker 5 question model to reach an answer.
Solution
Question 1. Is it profitable? The answer seems to be Yes. The country was chosen because of its low cost of land and labour.
Question 2. Is it legal? The answer seems to be Yes, because the government has given permission for the plant to be built.
Question 3. Is it fair? There is no reason to suppose that it is not fair. The only stakeholders in the example are the government and the local population. Both seem to support the building of the plant, and this suggests that the project is fair.
Question 4. Is it right? The answer seems to be Yes. The project will bring jobs, wealth and economic growth. There are no obvious reasons why the project is ‘Not right’.
Question 5. Is it sustainable or economically sound? The answer seems to be Yes, because the plant will be built using modern technology that keeps environmental emissions at a low level. In this simple case, the decision to build the plant would be ethical.
Post-Test
Write short note on Tucker’s 5 question model for ethical decision-making in business.

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LECTURE TWELVE

ETHICS, GOVERNANCE AND SOCIAL RESPONSIBILITY

12.0 Introduction

Business entities operate within society. They interact with their local communities. Their employees, customers and suppliers are all members of the society in which the entity operates. The responsibilities of a business entity towards society fall under corporate governance. There is a link between ethics, corporate governance and social responsibility.

Objectives

At the end of this lecture, students should have a good understanding of:-

1. Theories relating to corporate governance
2. Johnson and Scholes: Four possible ethical stances for a business entity

Pre-Test

1. What is corporate social responsibility?
2. What is corporate governance?

CONTENT

12.1 Shareholder theory

The shareholder theory of corporate governance is based on the view that the objective of a company is to maximize value for its shareholders. It has been suggested that a teleological approach to ethics can be used to justify the profit motive in business, so that the objective of maximizing shareholder wealth is perfectly legitimate. Shareholders, especially shareholders of large stock market companies, often trade their shares. Some are investors in the company for the long term and others invest only for the short term, hoping to make a quick profit from a favourable movement in the share price.

□□Long-term shareholders are likely to support the view that the company should invest for long-term growth. If necessary, short-term profits should be sacrificed in order to invest more retained profits in the business.

□□Short-term shareholders are likely to support a policy of high dividend payments and measures to boost short term profits.

12.2 Stakeholder theory

The stakeholder theory of corporate governance is that a company's directors owe a duty to all major stakeholders in the company, including not just employees and customers, but also communities and society as a whole. According to the normative view, a company has a moral duty to consider the concerns of various stakeholder groups.

This concept of governance can be linked to a deontological approach to business ethics. This would argue that all individuals have a basic moral right to be treated by business entities in a way that respects their interests and concerns. Employees should not be treated simply as a means to achieving the end of higher company profits.

The rights of stakeholders can be analyzed in terms of stakeholder groups (employees, customers, shareholders and so on) rather than considering each stakeholder individually. The possession of intrinsic moral rights by stakeholders creates corresponding ethical duties for a company to respect to those rights.

12.3 Social contract theory

There is also a social contract theory of corporate governance. This is based on the view that members of society give legal recognition to a company. They allow the company to exist and act as a legal person within society. They also allow a company to use land and resources, and to hire members of society as employees.

The company therefore has an obligation to pursue the objective of making profits only in ways that will also enhance the material well-being of society as a whole. Profit-making must be ethical and a company must consider the interests of society in the decisions and actions that it takes.

12.4 Ethical stance: personal and corporate

An ethical stance or posture is a position that someone takes on an ethical issue. Both individuals and organizations can develop a conscious ethical stance on certain issues, their decisions and actions are affected by it. For example, a company might take the view that it will not do business with certain types of customer or supplier. The ethical stance in a company comes from the moral values and ethical stance of key individuals who work within the company, and from the corporate culture.

12.5 Johnson and Scholes: four possible ethical stances for a business entity

Johnson and Scholes (2002) have suggested that companies can take any of four possible ethical stances. These are consistent with the differing views of corporate governance. The four ethical stances are to focus on:

- Maximizing short-term shareholder interests (the ‘least ethical’ of the four stances)
- Maximizing long-term shareholder interests
- Multiple stakeholder obligations: recognizing obligations to different stakeholder groups
- Being a shaper of society

12.6 Shaper of society

‘Shaping society’ means changing conditions in society and altering the way that society operates and perceives itself. In the past (and probably also the present), technology has been a significant shaper of society, affecting how and where we all live. Media companies have also been cited as important shapers of society in the past 100 years or so, because film has changed the way in which society viewed itself. Companies control resources and make decisions about the future of technology. They are instrumental in shaping society. Johnson and Scholes argued that ethical companies recognize this role that they have, and their decisions and actions are taken with a view to creating benefits for society and improving the well-being of society.

Post-Test

1. Write short note on Shareholders’ theory, Stakeholders’ theory and Social contract theory.
2. Johnson and Scholes (2002) have suggested that companies can take any of four possible ethical stances. These are consistent with the differing views of corporate governance. Required: What is ethical stance? Briefly explain the four possible ethical stances according to Johnson and Scholes (2002).

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