**Solutions manual**

to accompany

**Accounting: business reporting for decision making**

**7th edition**

by

Birt et al.

Prepared by

Suzy Maloney & Jenny James



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**Chapter 2: Accounting in society**

**Apply your knowledge**

**Financial acumen may not be every director’s strength but ignorance is no excuse when it comes to understanding company accounts. The former directors of property group Centro found this out the hard way when the Federal Court brought down its landmark decision against them regarding their lack of due diligence in the lead-up to the company’s near collapse in 2007.**

**The eight former directors and executives were found to have breached the Corporations Act by signing off on financial reports that failed to disclose billions of dollars of short-term debt. The case was watched closely by boards of directors across Australia, although the recently announced penalties were considered lenient. Declarations of contravention were made against all defendants.**

**Regardless of the lightness of the penalties, the case will continue to hold important lessons for Australian company directors. In his ruling, Federal Court judge John Middleton commented that the omission of more than A$2 billion of debt from the accounts could have been identified ‘without difficulty’. What was required of the directors was ‘critical and detailed attention’, rather than relying on the information presented to them by management and Centro’s auditors PricewaterhouseCoopers ‘no matter how competent or trustworthy they may appear to be’.**

**The Centro case will continue to be upheld as a prime example of what can go wrong when directors rely on others for information rather than make it their business to read the financial statements and check them.**

**‘The judgement is more of a wake-up call to say “don’t skim the accounts and don’t rely on the assurances of others. You need to exercise judgement and use an inquiring mind”. Which is consistent with the legal principles that directors have to be pro-active when it comes to understanding company affairs including its financial affairs,’ he (Anil Hargovan) says.**

**Leigh Warnick, a partner with Lavan Legal in Perth, says there are two key messages company directors and their advisers should take home from the Centro judgement: directors are the last line of defence on financial reporting; and information overload is no excuse — directors must take control.**

**Directors across Australia would be entitled to react to the Centro case with alarm if it obliged them to read financial statements with the eyes of an expert, but this is not the case, Warnick says. The requirements outlined by Justice Middleton were to have enough financial literacy to understand basic accounting conventions, and to exercise proper diligence in reading financial statements.**

[**John Colvin**](http://www.companydirectors.com.au/General/Header/About-Us/Overview-and-Corporate-Profile/Executive)**, managing director and chief executive of the Australian Institute of Company Directors (AICD), says the judgement against the Centro directors highlights important issues and provides some timely reminders of the significant responsibilities that come with a board seat and just how difficult being a director can be. ‘It is important for all company directors to have an understanding of the business they oversee, as well as a basic understanding of the financial position of the company,’ says Colvin. However, in an environment where the complexity of financial reporting standards and their application continues to increase, the role of company directors continues to become even more onerous.**

**The Centro judgment reminds directors that they are entitled to rely on specialist knowledge and advice provided by management and external advisors, but cautions directors that there are limits to that reliance, according to Colvin. ‘Board members should apply their individual, considered judgment to matters that are highly significant to the company before approving financial statements, and while we (at the AICD) agree that “directors are an essential component of corporate governance”, we are of the view, that it is not the role of non-executive directors to be involved in the day-to-day management of the company,’ says Colvin.**

**‘You may find that some directors are not confident about their ability to understand the basic accounting concepts in the financial statements,’ says Warnick. ‘The only safe option for directors in this position is to take an appropriate course to improve their skills.’**

***Source:* BusinessThink 2011, Directors’ notes post Centro: How to avoid barking up the wrong tree, UNSW Australian School of Business, 13 September, www.businessthink.unsw.edu.au.**

**Required:**

**a. Discuss the main issues for directors that are evident in the extract above. (4 marks)**

**b. Critique the judgement made in the case regarding the level of financial knowledge required of directors. (4 marks)**

**c. Suggest the consequence of the Centro decision for the diversity of Australian boardrooms. (4 marks)**

**d. A continuing controversial topic relating to management and the board is remuneration. Given the decision in the Centro case, predict the consequences for the remuneration of board members and the effect this would have on other stakeholders. (4 marks)**

1. **Discuss the main issues for directors that are evident in the extract above.**
   1. Ability to read financial statements.
   2. Reliance on experts.
   3. Duty of care required under the Corporations Act (directors under corporation act need to act with care and diligence).
   4. Skills such as assertiveness, inquiring mind, confidence to speak and ask questions are necessary. As is the time needed to understand complex reports (complexity, thick board papers and little time is no excuse).
   5. Delegation (what can and can’t be delegated).
2. **Critique the judgement made in the case regarding the level of financial knowledge required of directors.**
   1. Discussion could centre around the comments made in the article about whether directors need to be skilled in accounting versus that they need to have some minimal knowledge of accounting to ensure that the business dealings that they are aware of are presented and included in the accounts. There is a need to apply themselves to the task at hand and, if unsure whether some dealings are included, to ask and have it explained.
   2. This issue also dovetails into what can be delegated. Tasks can be delegated but not responsibility/obligations. Therefore, can delegate preparation of financial statement and take advice but ultimate decisions to approve is directors’ responsibility.
3. **Suggest the consequence of the Centro decision for the diversity of Australian board rooms.**
   1. A central issue here is that of risk. The increased risk of directors to be personally liable for honest mistakes, oversights and/or overreliance may decrease diversity. (The pool of people willing to undertake the position would decrease.) The court’s decision sends a message that directors need to be more diligent when approving the financial statements. Some may view this as being expert in the interpretation of accounting standards and their application to the financial statements at hand. This may heighten the risk for some individual directors with the result that they may prefer not to be a director. It may also increase costs if they seek second opinions from experts. This cost will be passed onto the company.
   2. On the other hand, the decision may heighten the consideration of the diversity needed on the board. Obviously, a board needs someone with good financial literacy that can be relied upon to speak openly and independently about the financial statements. Just like the board needs product/service experts (depending on the type of company, for example, BHP would have mining engineers on their board that could understand in-depth technical jargon in relation to their operations), marketing/HR/legal/PR experts may also be desirable. Although the inclusion of various experts does not negate the potential liability of others, it could reduce the risk if individual directors know they are being relied upon more heavily in a particular area. It also doesn’t negate the need for others to read or consider reports but that a particular director will ensure a more thorough reading.
4. **A continuing controversial topic relating to management and the board is remuneration. Given the decision in the Centro case, predict the consequences for the remuneration of board members and what effect this would have on other stakeholders.**

Risk and reward are linked. Heighten the risk and the reward is expected to increase. This could mean an increase in the remuneration of directors.

**Comprehension questions**

**2.3 Describe the structure of corporate governance as put forward by Farrar.**

Farrar (2008) sees the corporate governance structure as a relationship between the legal regulation, the stock exchange listing requirements and statement of accounting practice, codes of conduct, guidelines and statement of best practice, and business ethics. The legal regulation sits at the core, with the factors emanating outwards depending on their obligatory nature.

**2.4 Compare and contrast the views of Hobbes with those of Smith and Friedman.**

Hobbes viewed regulation as essential whereas Smith and Friedman advocated little regulation and the promotion of self-interest thereby creating market efficiencies and wealthy nations by free entrepreneurial trade.

Thomas Hobbes’ (1588–1679) famous position is that if everyone acted in their own self-interest, then anarchy would reign and it would lead to a shallow, anxious and short life. He argued that most people would rationally recognise that it was in their best interest to form a government to regulate behaviour. In so doing, they would accept the laws of the state and agree to abide by their moral obligations (Honderich, 1995).

However, maximising self-interest became a theme in classical economic theory. Adam Smith (1723–1790) was an advocate of this philosophy and believed that competitive self-interests were necessary in the commercial world to achieve overall public benefit. Basically, if people were free to venture into activities that promoted their own self-interest, then the process would guide them not to war on each other (as believed by Hobbes) but to a utilitarian state. Economist Milton Friedman also believed in limited government intervention and in the self-interest principle as long as it was done in accordance with the ‘rules of the game’. He states

‘there is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profit so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.’ (Friedman, 1970, p. 126)

Friedman’s laissez faire economy, in which profit is the ultimate goal and there is very little regulation, is based on the idea that a firm taking on social costs makes them less efficient and therefore in the long run will do more harm to society then good. So Smith and Friedman’s view of little regulation is in contrast to Hobbes’s position of a government ruled society. Although at seemingly opposing ends, the Smith and Friedman view is premised on an acceptance that some regulatory controls are needed; however, the question remains as to what extent regulation is needed to protect the interest of the community while not stifling the risk taking ventures of entrepreneurs that provide the impetus for wealthy nations. In other words, what are the rules of the game and how and who decides upon them?

**2.5 Outline the major maxims of Kantianism and describe what they mean.**

‘I ought never to act except in such a way that I can also will that my maxim should become a universal law.

Act in such a way that you always treat humanity … never simply as a means, but always at the same time as an end.’[[1]](#footnote-1)

The first of these maxims is similar to the ‘do unto others as you would have them do unto you’. If you take out credit knowing that you couldn’t pay it back, would you like a universal law that dictates that this is acceptable practice? The second maxim is that the end does not justify the means; to put it another way, you should not take advantage of people to achieve a certain end.

**2.6 One of the limitations of accounting information is the historical nature of the financial reports. Provide an example of an asset from the statement of financial position of Qantas Group where the asset’s historical cost may not reflect its current value.**

One example of an asset where the reported historical cost may not reflect is current value is property, plant and equipment. The note to the financial statements state that the property, plant and equipment are stated at cost less accumulated depreciation and impairment (if any). This amount may not reflect its current value. Impairment tests allow for the asset to be written down if its carrying amount exceeds its recoverable amount. However, there is no provision for any revaluation upwards.

**2.7 What are the benefits of professional association membership for accounting graduates?**

Benefits include:

* further education through the CPA, CA and MIPA programs
* technical assistance on accounting standards and the *Framework*
* support for graduates through the resources on the web, seminars and continuing education programs
* guidance in relation to the code of ethics for professional accountants.

**2.8 Discuss whether an accountant should take on an appointment outside their area of expertise.**

The APES 110: *Code of Ethics for Professional Accountants* requires an accountant to perform professional services with due care, competence and diligence. This includes ensuring that they possess a level of technical and professional skills to take on appointments. It is clear, therefore, that an accountant should not take on an appointment outside their area of expertise.

**2.9 Compare and contrast the roles of the Financial Reporting Council (FRC) and the Australian Securities Exchange (ASX).**

The FRC is a statutory body made up of key stakeholders from the business community, the professional accounting bodies, governments and regulatory agencies. The FRC’s role is to oversee the accounting and auditing standard setting process for both the public and private sectors in Australia. The ASX contributes to company regulation in Australia as it regulates listed entities on the stock exchange through its Business Rules and Listing Rules which are in addition to the regulations in the Corporations Act.

**2.10 What is the difference between the revised Conceptual Framework’s fundamental qualitative characteristics of relevance and faithful representation? Can you think of any trade-offs between relevance and faithful representation?**

Relevance implies that the information should have predictive and confirmatory value for users in making and evaluating economic decisions. Faithful representation implies that the information fully represents the phenomena it purports to represent. This means that the financial information will be complete, neutral and free from error.

A trade-off can occur between relevance and faithful representation. An illustration of this would be the accounting practice of estimating doubtful debts expense. The process of estimating doubtful debts expense is relevant to the decision making process. It is necessary to determine an estimate so that revenues for the period can be appropriately matched with the expenses for the period. However, if you estimate doubtful debts expense the estimate that you use does not faithfully represent the actual amount of bad debts expense (i.e. is unlikely to be an amount free from error). However, the process of estimating the expense is useful to the decision maker.

**2.11 Imagine that you are a manager in a large entity and need to make a recommendation to the CEO on which tender to accept. The job being put out to tender by the entity is worth millions of dollars and you have a significant ownership share in one of the companies tendering. Outline the ethical issues to be considered.**

The issues to consider are independence, conflict of interest, objectivity and integrity. In your position as manager, you need to act in the best interests of the company and make an independent and objective assessment as to which of the tendering companies should be given the tender. If the company in which the manager had an interest won the tender, there may be doubts from others as to whether it was because it was the best tender or because there was bias in the decision-making process. It would be best for the manager to declare his interest and to step back from the decision.

**2.12 How can the professional accounting bodies assist in standard setting?**

Professional bodies such as CPA Australia and the CAANZ provide feedback on exposure drafts and forward any comments on to the AASB. They also inform their members of any accounting standard developments through newsletters and by conducting Continuous Professional Education (CPE) sessions. The professional bodies’ websites provide ongoing advice and information on a range of topics including the adoption of IFRS, the *Framework* and compliance issues.

**2.13 Describe the major purpose of the ASX. What types of information does it provide for a novice investor?**

The Australian Stock Exchange (ASX) assists in regulating companies through its market and listing rules. This ensures that trading takes place in an orderly and fair manner. The ASX oversees the operations and behaviour of those companies listed on the ASX and helps ensure that companies are providing true and fair accounting information to various stakeholders such as a novice investor. A novice investor can refer to the ASX to get information about shares, bonds and other securities of a listed company in order to make appropriate investing decisions.

**2.14 What are the four key responsibilities of business? Do you think an entity should consider discretionary responsibilities? Why or why not?**

According to Carroll, there are four key responsibilities of business which are economic, legal, ethical and discretionary. Organisations have an economic responsibility to provide goods and services at a fair price, to repay their creditors and to seek a reasonable return for their shareholders. Legally, they are required to uphold the laws of government and are ethically responsible to act the way society would expect. Discretionary responsibilities are carried out voluntarily. For instance, there may be no laws relating to the maximum volume of effluent discharge, but a company may choose to monitor and limit its discharge because society expects it to. It is an ethical responsibility. However, the firm may also choose to change equipment and processes so that there is no discharge at all and this would be classed as a discretionary responsibility. Over time, discretionary responsibilities may become ethical responsibilities or even legal responsibilities. If organisations don’t address their pollution problems, the government will step in and regulate it.

Whether or not you feel that firms should consider discretionary responsibilities depends on your view as to the objective of a firm. As discussed in the chapter, some believe that a firm only has a duty to its shareholders, while others believe that a firm has a wider responsibility to all stakeholders. Some reasons put forward why firms consider social and environmental issues are:

 economically in their best interest (has a benefit to the bottom line profit)

 to minimise government interference

 enlightened self interest

 genuinely want to do the right thing.

So, what you believe will determine whether or not a firm has a responsibility to consider discretionary responsibilities.

**2.15 What is the impact of the qualitative characteristic of ‘materiality’ on the preparation of the financial statements?**

The qualitative characteristic of ‘materiality’ is another important assumption in accounting. According to the accounting and legal profession, material information is that which affects the decisions made by users of the financial reports in which the information is disclosed. Determining a material item should include a quantitative and qualitative evaluation of that item. The factors that need to be considered are type of entity, size of entity and the industry that the entity is operating in. Significant professional judgment is necessary. The impact of this characteristic on the preparation of financial statements is that information is only disclosed if it affects the decisions made by users of financial reports. Therefore, in financial reports, amounts are rounded up to the nearest thousand or ten thousand. Individual assets are not listed in the statement of financial position — the notes to the financial reports would provide a description of assets under each class of asset on the statement of financial position.

**2.16 In your own words, explain the advantage of comparability and transparency of financial information due to the adoption of IFRS.**

One of the advantages of adopting IFRS is the increase in comparability of financial information. A single set of global standards would lead to greater consistency in financial reporting as jurisdictions following IFRS would be producing reports under a similar set of guidelines. Adopting IFRS would also lead to more transparency in financial reports as information under IFRS would be accessible, visible and understandable to all market participants. Most IFRSs are more detailed compared to local GAAP.

**2.17 ‘Complying with the law will always mean that you are acting ethically.’ Discuss this statement.**

Ethics and the law are related but they are not the same thing. Law is about what actions are legal, not particularly what is ethical. Justice may or may not be seen to be done in a court of law.

A good way of thinking about this is by considering Carroll’s four key responsibilities of business (economic, legal, ethical and discretionary). Specifically, consider the legal and ethical responsibilities. Legally, businesses are required to uphold the laws of government and are ethically responsible to act the way society would expect. For instance, there may be no laws relating to the maximum volume of effluent discharge but a company may choose to monitor and limit its discharge because society expects it to. It is an ethical responsibility.

**2.18 Are ethics and corporate governance important topics in the study of accounting and the business environment? Why or why not?**

Yes. It is necessary to study ethics because ethics is about human behaviour. Business is also about the behaviour of humans, and decisions made in business can alter the fate of individuals, groups, organisations and even countries. Corporate governance is about the ultimate decision making of enterprises. The boards of companies and the top executives make decisions that have far-reaching consequences. They are entrusted with billions of dollars of capital, the labour of the world and the futures of not only the current generation but subsequent generations. It is therefore important that people entering the business world understand that responsibility and therefore that guidelines, expectations and an understanding of ethics be incorporated into business studies.

**2.19 Explain the relationship between the Australian Accounting Standards Board (AASB) and the International Accounting Standards Board (IASB).**

The AASB is responsible for the development of accounting standards to be followed when preparing GPFRs (general purpose financial reports). The standards have the force of law under the Corporations Act. Disclosing entities, public companies and large corporations must apply the standards when preparing their financial reports. Since 2005, the AASB has released AIFRS — Australian Equivalents of International Financial Reporting Standards issued by the IASB.

**2.20 Briefly describe how the AASB develops accounting standards.**

Since 1 January 2005, Australian entities have complied withInternational Financial Reporting Standards (IFRS). The Australian Accounting Standards Board (AASB) is responsible for the development and maintenance of high-quality financial reporting standards in Australia, and to contribute to the ongoing development of global accounting standards. The AASB provides input into current accounting standards issued by the IASB by contributing to the due process. The due process of an accounting standard includes identifying a technical issue through submissions and other materials from interested parties; developing a project proposal to determine if the project is worthwhile; researching the issue comprehensively; issuing an exposure draft, discussion paper or an invitation to comment; and issuing a draft interpretation.

**2.21 Comment on the approach put forward by The Ethics Centre in deliberations of an ethical issue.**

The Ethics Centre Approach helps identify the issues to think about in making a decision, rather than a sequential approach. The method is as follows.

 What are the relevant facts?

 Which of my values make these facts significant?

 What assumptions am I making?

 What are the weaknesses in my own position?

 Would I be happy for my actions to be open to public scrutiny?

 Would I be happy if my family knew what I’d done?

 What will doing this do to my character or the character of my organisation?

 What would happen if everybody took this course of action?

 How would I feel if my actions were to impact upon child or parent?

 Have I really thought through the issues?

 Have I considered the possibility that the ends may not justify the means?

**2.22 How do accounting standards assist large companies?**

The Corporations Act stipulates that large companies must apply accounting standards in preparing their financial reports. The accounting standards assist with consistency in financial reporting and ensuring the users of financial reports (e.g. investors, consumers, employees, regulatory bodies) will have the necessary relevant and faithfully representative information to assist them in their decision making. Without accounting standards, there would be no comparability in financial accounting: firms would produce a statement of profit or loss with differing amounts of information. Some firms would report large number of intangible expenditure and others would report minimal amounts or none at all. A lack of consistency would make it impossible to compare one firm against another.

**2.23 What is an IFRS and how does it impact on standard setting in Australia?**

Australia adopted Australian equivalents to International Financial Reporting Standards (IFRS), from 1 January 2005. The adoption of IFRS helps ensure compliance with internationally agreed principles, standards and codes of best practice. The adoption of IFRS also reduces the amount of standard setting in Australia by the Australian Accounting Standards Board (AASB), which allows the AASB to focus on providing expert advice on some of the International Accounting Standards Board future projects and interpreting issues arising out of the adoption of IFRS.

**2.24 Identify and discuss five fundamental principles of the Code of Professional Conduct.**

The five fundamental principles espoused in the code to guide a member’s decision making include the following.

1. Integrity — be straightforward, honest and sincere in your approach to professional work.
2. Objectivity — do not compromise your professional or business judgement because of bias, conflict of interest or the undue influence of others; be fair and do not allow prejudice, conflict of interest or bias to override your objectivity.
3. Professional competence and due care — perform professional services with due care, competence and diligence. Carry out your professional work in accordance with the technical and professional standards relevant to that work; maintain professional knowledge and skill at a level required; and refrain from performing any services that you are not competent to carry out unless assistance is obtained.
4. Confidentiality — respect the confidentiality of information acquired in the course of your work and do not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose it; and refrain from using confidential information acquired as a result of the professional engagement to your advantage or the advantage of third parties.
5. Professional behaviour — conduct yourself in a manner consistent with the good reputation of the profession and refrain from any conduct that might bring discredit to the profession.

**2.25 What is risk management and why is it included in the ASXCGC *Corporate Governance Principles and Recommendations*?**

Risk management is the systematic process of assessing the probability of something unexpected happening, and the establishment of policies and procedures to manage that risk. It is important for the board and management of enterprises to consider risk in order to understand properly the impact of the environment of their enterprise and to help ensure its survival into the future. It is included in the ASX principles of good corporate governance as it is fundamental for the decision makers in any enterprise to manage risk.

**2.26 Give some examples of each of Carroll’s four key responsibilities of business. Have any of these changed from one responsibility grouping to another over the last decade?**

The four key responsibilities of business are economic, legal, ethical and discretionary. Many examples could be given.

1. *Economic* — to provide goods at a fair price, to pay creditors on time, to ensure a suitable return to shareholders.

2. *Legal* — to comply with the laws (i.e. submit financial reports on time, adhere to pollution regulation, comply with trade practices act dealing with fair pricing and market exploitation).

3. *Ethical* — to treat employees fairly.

4. *Discretionary* — to provide childcare facilities for workers.

There would be a number of items that would have gone from the ethical grouping to the legal grouping, especially those issues relating to the environment. Issues such as pollution emission and effluent discharge may not have been regulated to the same extent 50 years ago. Childcare facilities are one example that may go from discretionary to ethical over the next decade with pressure on companies to provide such facilities.

**2.27 Explain the following:**

**a. triple bottom line reporting**

**b. corporate governance**

**c. the relationship of stakeholders to corporate governance.**

**a. Triple bottom line reporting:**

Triple bottom line reporting refers to the economic, social and environmental performance of a company. Elkington proposes that a company’s long-term viability is a function of how well it can balance the three areas. The concept supports the view that companies have a duty of care to society at large. The movement is developing performance measures to assist the analysis of social and environmental performance.

**b. Corporate governance:**

Corporate governance refers to the direction, control and management of an enterprise.

**c. The relationship of stakeholders to corporate governance:**

There is much debate in business literature as to whether an organisation’s sole responsibility is to its shareholders, or whether there is a wider duty of care for organisations to identify all the values and principles at stake. A theory called ‘stakeholder theory’ proposes that the purpose of the firm ‘is to serve as a vehicle for coordinating stakeholder interests’, not the narrow view that the purpose is to maximise shareholder wealth. After all, the firm is an artificial entity and the shareholder purpose of the firm is simply based on the shareholder’s right to property. Proponents of stakeholder theory view the purpose of a firm as far greater.

It is related to corporate governance because corporate governance is about the direction, control and management of organisations. Therefore, the management of the nation’s capital and operations rests on the philosophy of the company directors that have the responsibility to govern enterprises. How and to what extent they consider all stakeholder views will have an impact on society in the long term.

**2.28 Outline the corporate governance principles and recommendations.**

The Australian Stock Exchange (ASX) corporate governance principles and recommendations 3rd edition, are as follows.

1. Lay solid foundations for management and oversight.

2. Structure the board to add value.

3. Act ethically and responsibly.

4. Safeguard integrity in corporate reporting.

5. Make timely and balanced disclosure.

6. Respect the rights of security holders.

7. Recognise and manage risk.

8. Remunerate fairly and responsibly.

**2.29 Outline the legal duties that directors have to their company.**

Generally, directors owe the following legal duties to their company:

 to act in good faith, in the best interests of the company

 to act with care and diligence

 to avoid conflicts between their role as a director and any of their personal interests.

**2.30 Compare and contrast the professional code of ethics for individuals and the guidelines for corporations.**

Both require care and a consideration of the public interest. There are minimum standards expected (technical and professional standards for individuals and best practice standards for corporations) and there is a need for transparency and accountability. Personal attributes of officers of companies referred to in the guidelines and for accountants in the professional code of ethics are competence, integrity and objectivity. Related to these attributes is independence. Independence is an important element in accounting professional services and contributes enormously to the trust the public have in accountants and their role. It is included in the code of professional ethics. It is therefore not surprising that it is an important element of principle 4 in the guidelines which relates specifically to the accounting function of safeguarding the integrity of the financial reports.

**2.31 What is the difference between business ethics and social and environmental responsibility?**

Business ethics relate to values and principles used in individual decision making, whilst social and environmental responsibility relates to the consequences of the actions of corporations on society and the environment.

**Exercises**

**2.32 Australian Accounting Standards**

There are at least 60 Australian Accounting Standards. Go to the AASB website at www.aasb.gov.au and choose one. (Hint: Go to ‘Quick Links’ and select ‘Table of Standards’.) One of the recent accounting standards is the standard on fair value measurement. Briefly describe the meaning of ‘fair value’ accounting. What is the purpose of this standard?

AASB 13 Fair Value is a recent accounting standard issued by the AASB. Fair value is a market-based measurement. For some assets and liabilities, observable market transactions or market information might be available. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or transfer the liability would take place between market participants at the measurement date under current market conditions.

The purpose of the standard is to define fair value and set out a single standard for measuring fair value and the required disclosures in the notes arising out of applying fair values to assets and liabilities.

**2.33 The AASB, as part of its work program, offers comment on documents such as proposed agenda decisions, exposure drafts, draft exposure drafts, invitations to comment and discussion papers. Go to the ‘Work in progress’ page of the AASB website at www.aasb.com.au and choose ‘Pending’. One of the topics listed relates to the exposure draft — ED 259 Classification of Liabilities. Summarise the main changes to this proposed standard.**

ED 259 *Classification of Liabilities* clarifies that the classification of liabilities as either current or non-current is based on the rights that are in existence at the end of the reporting period.

In order to make this clear, the IASB proposes: (a) replacing ‘discretion’ in paragraph 73 of the Standard with ‘right’ to align it with the requirements of paragraph 69(d) of the Standard; (b) making it explicitly in paragraphs 69(d) and 73 of the Standard that only rights in place at the reporting date should affect this classification of a liability; and (c) deleting ‘unconditional’ from paragraph 69(d) of the Standard so that ‘an unconditional right’ is replaced by ‘a right’. The IASB also proposes making clear the link between the settlement of the liability and the outflow of resources from the entity by adding that settlement ‘refers to the transfer to the counterparty of cash, equity instruments, other assets or services’ to paragraph 69 of the Standard. The IASB further proposes that guidance in the Standard should be reorganised so that similar examples are grouped together.

Source: <http://www.aasb.gov.au/admin/file/content105/c9/ACCED259_02-15.pdf>.

**2.34 Fraud**

**A survey conducted by PwC in 2018 shows that 45 per cent of organisations experienced customer fraud in the last two years. Likewise, 43 per cent suffered a cyber attack. The most common type of cyber attacks were: phishing (48 per cent), malware (39 per cent), and network scanning (24 per cent). External actors accounted for 64 per cent of economic crime in Australia.**

**Comment on whether fraud is just part of doing business. Outline five steps organisations can take to fight against economic crime.**

This is an opinion-based question. Some discussion points are as follows.

* Some students may feel it is part of normal business activity and others may argue they should have zero tolerance. The point of view will determine whether a business allows for the cost of fraud in pricing or have zero tolerance.
* If they allow it in pricing then it is being passed on to the customer and, ultimately, the community is paying.
* If covered by insurance, the community is still paying.

Five steps organisations can take to fight against economic crime include the following.

1. Treat economic crime holistically — consider your entire threat environment including frenemies, internal and external threats in an integrated way.
2. Focus on prevention — understand your vulnerabilities and how they are continually changing over time.
3. Commit resources — only 25% of organisations surveyed had a dedicated team to address economic crime.
4. Leverage advanced technologies — less than 15% of organisations surveyed were using machine learning, natural language processing, natural language generation, voice recognition, predictive analytics or artificial intelligence to prevent and detect fraud.

5. Keep investing in people — machines can only do so much; you also need to address human behaviours that increase your organisation’s vulnerability to crime.

Source: PwC 2018, *The new face of economic crime,* p. 10, [www.pwc.com.au](http://www.pwc.com.au), viewed 4 October 2018.

**2.35** Professional institutions

**CPA Australia and CAANZ have designated areas on their websites for technical resources and updates. Go to each of the respective bodies’ websites (**[www.cpaaustralia.com.au](http://www.cpaaustralia.com.au)**, www.charteredaccountantsanz.com) and summarise the resources provided.**

CPA Australia and CAANZ have various resources to assist members with adopting AIFRS. These resources include:

* articles on adopting IFRS
* draft submissions from the professional associations on IASB’s exposure drafts
* latest news in relation to IFRS
* IFRS compared to IFRS and the old GAAP
* interpretations and guidance
* IFRS fact sheets
* IFRS implementation kit for the public and private sectors.

**2.36** Conceptual Framework and accounting standards

**Describe the relationship between the revised Conceptual Framework and accounting standard AASB 116 Property, Plant and Equipment.**

The Australian accounting standards have the force of law under the Corporations Act for disclosing entities. The revised *Conceptual Framework* contains statements to assist in the preparation and presentation of financial reports; however, it does not have the force of law and therefore its role is more to substantiate the accounting standards and provide further guidance on the application of the standards.

AASB 116 *Property, Plant and Equipment* sets out the requirements for accounting for the non-current asset property, plant and equipment which for most companies is one of the largest assets. The revised *Conceptual Framework* includes the definitions of the elements of the financial reports such as assets, liabilities, expenses, revenues and equity. AASB 116 will apply the definition of asset as outlined in the revised *Conceptual Framework* and use it as a base and point of reference for the definitions relating to property, plant and equipment in the actual standard.

2.37 Corporate governance and sustainability

**I put it to you that the directors are responsible to the shareholders for profit in perpetuity; and that this general expression of a principle permits, indeed requires, directors to pay full regard to their employees, to labour relations generally, to the community, to the country, in all their decisions for and on behalf of shareholders (Dunlop, 1987).**

Discuss the implications of Sir John Dunlop’s statement.

The first part of the statement clearly indicates that he believes a corporation’s responsibility is to its shareholders. He indicates that this is a duty in ‘perpetuity’ or in the long term. The second part then indicates that he believes that to carry out this responsibility, a corporation has to consider all stakeholders. It could be argued that he is professing the ‘enlightened self-interest’ principle.

**2.38 Corporate governance**

**Outline some of the legal constraints in legislating for the consideration of stakeholder interests.**

A number of constraints are listed below.

1. It would be difficult for a board to be legally held accountable for all stakeholder interests. At times, acting for the benefit of one stakeholder group may clash with another stakeholder group.
2. It could be seen as infringing on the property rights of the shareholders (who own the company).
3. There could be problems with regulating how a board is held accountable in balancing stakeholder interests. Could this be proved in a court of law? What evidence would be needed?
4. It could be difficult to identify stakeholders that the legislation would protect.
5. Processes for stakeholders to enforce their rights under the legislation could be difficult to establish.
6. Allowing a broader group to whom the board is responsible may water down their responsibility to anyone.

Generally, many people may argue that most stakeholders or groups could seek remedy under existing legislation (i.e. employees under workplace health and safety laws and awards) and that expanding the duties of directors would unduly increase their personal risk and liability resulting in a withdrawal of leadership talent, without the commensurate benefits to society.

2.39 Code of ethics

**Members of the two accounting professional bodies, CPA Australia and the Chartered Accountants of Australia and New Zealand (CAANZ), have to comply with the *APES 110* *Code of Ethics for Professional Accountants*. This code lists several possible threats to the fundamental principles. Look up the APESB website (**[www.apesb.org.au](http://www.apesb.org.au)**) and outline some examples of each of the five threats.**

Those threats include self-interest, self-review, advocacy, familiarity and intimidation. Examples from APES 110 are as follows.

Examples of circumstances that may create self-interest threats for a member in public practice include, but are not limited to:

• a financial interest in a client

• jointly holding a financial interest with a client

• undue dependence on total fees from a client

• having a close business relationship with a client

• concern about the possibility of losing a client

• potential employment with a client

• contingent fees relating to an assurance engagement

• a loan to or from an assurance client or any of its directors or officers.

Examples of circumstances that may create self-review threats include, but are not limited to:

• the discovery of a significant error during a re-evaluation of the work of the member in public practice

• reporting on the operation of financial systems after being involved in their design or implementation

• having prepared the original data used to generate records that are the subject matter of the engagement

• a member of the assurance team, being, or having recently been, a director or officer of that client

• a member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement

• performing a service for a client that directly affects the subject matter of the assurance engagement.

Examples of circumstances that may create advocacy threats include, but are not limited to:

• promoting shares in a listed entity when that entity is a financial statement audit client

• acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

Examples of circumstances that may create familiarity threats include, but are not limited to:

• a member of the engagement team having a close or immediate family relationship with a director or officer of the client

• a member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement

• a former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement

• accepting gifts or preferential treatment from a client, unless the value is clearly insignificant

• long association of senior personnel with the assurance client.

Examples of circumstances that may create intimidation threats include, but are not limited to:

• being threatened with dismissal or replacement in relation to a client engagement

• being threatened with litigation

• being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

2.40 Ethical decision-making models

**Your client MJM Ltd consults with you in relation to the new financial information system that it wishes to have installed. You are technically competent in this area, and so accept the engagement. You carry out an analysis of software available, and make a recommendation that the client accepts. You continue to be involved while the software is being installed.**

Discuss the effect of this engagement on you continuing as the client’s auditor. Use the Langenderfer and Rockness model to help with your answer.

*What are the facts?*

You are the auditor of a company and you have taken on a management advisory service.

*What are the ethical issues?*

The main issue is that of independence and objectivity. Could you now audit the financial reports which were produced by the very system you installed? It is not only enough that you are of independent mind but that you appear to be independent in the eyes of others. However, if you don’t take the audit engagement are you letting down the company who now has to find a new auditor which may result in an increased fee for the client?

*What are the norms, principles and values?*

Independence, objectivity, conflict of interest, owe a duty to shareholders, community and public as well as to client.

*What is the best course of action consistent with the principles of integrity?*

Not to take the audit.

*What are the consequences of the possible courses of action identified in 4 above?*

Option one is to undertake the audit and risk losing respect in the eyes of the shareholders and public with regard to independence and objectivity.

Option two is not to undertake the audit. This may have immediate consequences for the client, especially if there is limited time for the audit to be completed. It may also mean loss of fees for you in the future as you will be giving up a long-term engagement.

2.41 Corporate governance

Comment on the following situations in relation to the ASX CGC *Corporate Governance Principles and Recommendations.*

**a. A member of a board of directors insists on being involved in the employment of personnel.**

**b. The auditor of a company is the brother-in-law of one of the company’s directors.**

**c. The XYZ company ensures that as much information as possible about the operations and financial affairs of the company is made available on the company website.**

**d. The chairman of the board puts forward a proposal to remunerate the CEO. A member of the board questions the proposal, giving the opinion that ‘in comparison to similar size entities, it seems excessive’.**

**e. A board member is a major shareholder of a company that has tendered on a contract worth millions of dollars. When the board meets to consider the tenders received, the board member declares that she has a conflict of interest, and leaves the meeting room while the tenders are being discussed.**

a. The first principle encourages there to be a clear distinction between the responsibilities of the board and those of management. It would be strongly argued that management should oversee the employment of personnel.

b. Principle 4 recognises the need to safeguard the integrity of the financial reporting system. One safeguard is to ensure that the auditor is independent. If the auditor and a board member has a close personal interest, then in the eyes of the public the auditor would not be seen as independent and thus lose credibility.

c. Principle 5 recommends the timely and balanced disclosure to promote accountability and transparency.

d. Principle 8 recommends that remuneration has to be fair and reasonable and in line with performance.

e. Principle 2 states that an effective board is independent and objective.

2.42 Ethics

As the director of a company, you need to make a decision regarding whether to shift the manufacturing operations offshore. Over recent years, the influx of cheap imports has made it harder to compete on a cost basis. However, shifting the operations offshore will create job losses for a large number of local people. Your company is a major employer in the region, and the closure of the factory will have a significant economic effect in the area. Use The Ethics Centre method to identify the issues to consider.

*What are the relevant facts?*

Company is struggling to compete due to cost. It is cheaper to use overseas labour. Would result in large negative economic impact on local community. However, not to shift may result in the company failing.

*Which of my values make these facts significant?*

Integrity, trust, social commitment, reliability.

*What assumptions am I making?*

That the company may fail if the operations aren’t shifted. That the community relies on the business in totality. That there are no other ways of operating that can save the company and still enable its existence in the local community.

*What are the weaknesses in my own position?*

There could be other avenues for cost saving. Maybe the company does not need to make so much profit. Maybe the local community could be asked for help.

*Would I be happy for my actions to be open to public scrutiny?*

They would be open to public scrutiny and may feel as if I let the community down if the operations shifted.

*Would I be happy if my family knew what I’d done?*

Yes, if all avenues were exhausted and the decision to take the operations offshore was the necessary one. It may not only save the business but also some jobs to the community.

*What will doing this do to my character or the character of my organisation?*

May be seen as chasing the ‘dollar’ at the expense of the livelihoods of local families. May lead to a backlash on products.

*What would happen if everybody took this course of action?*

There would be no industry left in the local community and in this country.

*Have I really thought through the issues?*

Yes.

Have I considered the possibility that the ends may not justify the means?

The shifting operations offshore may result in some job losses but some positions may remain. If the operations continue as currently then the business may go bankrupt and all jobs would be lost.

**2.43** Disciplinary action

**Every time there is a spate of corporate collapses, the accounting profession has been closely scrutinised and many members of the professional bodies have appeared before disciplinary hearings. The professional bodies publish a professional conduct annual report each year. Go to Chartered Accountants Australia and New Zealand website at www.charteredaccountantsanz.com/. Search for ‘member complaints and discipline’. Click on ‘tribunal decisions’. Summarise five of the tribunal hearings and the nature of the allegations against the members of the accounting profession.**

*Instructor’s note*: expect a variety of responses here depending on which annual report is accessed.

Responses could include:

* failure to observe a proper standard of professional care, skill or competence
* failure to respond to a client’s correspondence on personal and business tax returns
* continuing practising as an accountant in a business that was in the process of liquidation
* failure to return client monies held in trust accounts
* failure to comply with the code of conduct.

2.44 Ethical decision-making models

You are faced with a number of situations as described. Use the Langenderfer and Rockness model to help determine the course of action you would take.

**a. You are a manager within a large entity and need to make a recommendation to the CEO on which tender to accept. The job being tendered for is worth millions of dollars, and you have a significant share in one of the companies tendering.**

**b. You are a small-business owner who wants to enter an overseas market. You arrange to meet with a government official of the country you wish to do business with, in order to discuss your market entry. To be successful, you really need his support. During the discussion, you realise that he expects a monetary payment in exchange for his help.**

**a. You are a manager within a large entity and need to make a recommendation to the CEO on which tender to accept. The job being tendered for is worth millions of dollars, and you have a significant share in one of the companies tendering.**

1. *Determine the facts of the case.*

Need to make a recommendation on tender. You have a material personal interest in a tendering company.

2. *Determine the ethical issues in the case.*

Conflict of interest and material personal interest.

3. *Determine the norms, principles and values related to the case.*

Independence, objectivity and integrity.

4. *Determine the alternative courses of action.*

(a) Declare an interest and step outside of the decision-making process for this particular tender.

(b) Declare an interest and remain part of the decision-making process and complete your recommendation for your company.

(c) Don’t declare an interest and continue to do your job by making a recommendation.

5.  *Determine the best course of action consistent with 3 above.*

Best course of action would be to declare an interest and disqualify yourself from taking part in the decision-making process for this particular tender.

6. *Determine the consequences of each possible course of action identified in 4.*

(a) This will communicate to the CEO and all companies dealing with the organisation that you are open and honest in your dealings and that independence is important. Your objectivity and integrity will remain intact.

(b) Although it is admirable that you have made your personal interest known, it is not known whether you can truly be objective in the decision-making process, given your interest. It is not only necessary that you are independent; you need to appear to be independent from a third party.

(c) This could bring your own character and the reputation of your company into disrepute.

7.  *Decide the course of action.*

It is best to declare an interest and step away from the decision making. This will strengthen the confidence in the company’s tendering process by showing that you are independent and the company handles fairly all tenders received.

**b. You are a small-business owner who wants to enter an overseas market. You arrange to meet with a government official of the country you wish to do business with, in order to discuss your market entry. To be successful, you really need his support. During the discussion, you realise that he expects a monetary payment in exchange for his help.**

1. *Determine the facts of the case.*

You need to make a monetary payment to a government official. Your market entry depends on his support. It is against your culture to make such payments but it seems expected in this new country as the way of doing business.

2. *Determine the ethical issues in the case.*

Bribery.

3. *Determine the norms, principles and values related to the case.*

Honesty and integrity.

4. *Determine the alternative courses of action.*

(a) Make the payment.

(b) Don’t make the payment.

5. *Determine the best course of action consistent with 3 above*

It is best not to make the payment as this is consistent with the principles of your own culture. If it was found out that a monetary payment was made, it may jeopardise your integrity at home.

6. *Determine the consequences of each possible course of action identified in 4.*

(a) If you make the payment, it would increase the likelihood of your business venture being successful. However, it would compromise what you believe to be right. It may also mean that further payments would be expected in the future by the government official. That is, once you made a payment you may need to continue to do so.

(b) If you don’t make the payment, you may find it hard to do business in that country. However, you may feel that you were uncomfortable doing business that way anyway. You would also feel that you were true to your own character of honesty and integrity by not making the payment.

7. *Decide the course of action.*

It is best not to make the payment.

**2.45 Code of ethics for professional accountants**

**You are an accountant with XYZ Ltd and are confronted with the situations described below. State in each case whether there has been a breach of the *APES 110* Code of Ethics for Professional Accountants.**

**a. You are appointed the auditor of Jones Ltd, a supplier of electronic devices. While on the premises carrying out some audit work, you are offered a new tablet in appreciation of your work to date.**

**b. You discover that your client, White Ltd, has overestimated its allowable deductions on its tax return. You ask the company to submit an amended return but it refuses.**

**c. You approach one of your friends, who works for a lending institution, for an unsecured loan. You have been unable to obtain a loan elsewhere. Your friend approves the loan.**

**d. You are on the local council works committee. It is considering a number of tenders for a library upgrade. Your best friend has submitted a tender, and you argue strongly in favour of that tender.**

**e. You have been approached to audit a large regional business. Your spouse is employed as a manager within the company.**

**a. You are appointed the auditor of Jones Ltd, a supplier of electronic devices. While on the premises carrying out some audit work, you are offered a new tablet in appreciation of your work to date.**

The gift of a tablet may not be seen as normally commensurate with acceptable social/business behaviour and could be construed that you may compromise your integrity, objectivity and independence. The code of ethics requires objectivity and independence. Accepting gifts may be seen to compromise your objectivity and independence. You must not only be independent of mind but also be seen to be independent. Integrity may also be hampered if accepting the gift.

**b. You discover that your client, White Ltd, has overestimated its allowable deductions on its tax return. You ask the company to submit an amended return but it refuses.**

This raises the issue of a duty to the public and a duty to a client. On the one hand, the code of ethics is based on the premises of credibility, professionalism, quality of service and confidence. The code of ethics states that accountants must maintain a sense of duty to the public interest. The public includes government. To discover an error and not report it may give you a sense that you have let down your responsibility to maintain a professional approach to your work, and a contribution in helping to establish confidence in the accounting profession and a credible and fair application of the tax system. On the other hand, you have a duty to your client. Generally, you may feel that you have done all that you can by requesting that they resubmit the return. It is a hard decision to report a client and you may feel that you prefer to extinguish your relationship to the client. It is probably in your best interest not to deal with such people anyway. Maybe a letter to your client outlining their responsibility, your responsibility and the consequences of their actions would help convince them and put you at ease that you have communicated with them fully and frankly in writing about the situation.

**c. You approach one of your friends, who works for a lending institution, for an unsecured loan. You have been unable to obtain a loan elsewhere. Your friend approves the loan.**

It is unfortunate that you placed your friend in this position. Given that no other institution approved the loan suggests that you received the loan because you were a friend rather than because you should have received a loan under the lending institution’s guidelines. The code states accountants should act with competence and due care. It seems that the person giving the loan has breached this. The person has also breached the public interest, integrity, objectivity and independence.

**d. You are on the local council works committee. It is considering a number of tenders for a library upgrade. Your best friend has submitted a tender and you argue strongly in favour of that tender.**

In this situation, it would have been appropriate to declare a conflict of interest and leave the meeting. By not doing this and arguing in favour of your friend’s tender, it is unclear as to whether you are arguing for it because you strongly believe it is the best tender or because it is your friend. Your objectivity is impaired. Although you could argue that you are independent in mind, you would not be seen to be independent by third parties. It would seem that integrity, objectivity and independence would be breached.

**e. You have been approached to audit a large regional business. Your spouse is employed as a manager within the company.**

The code states that you maintain independence. This means that you not only have to be independent of mind but also independent in the eyes of third parties. It is unlikely that you would be perceived as objective due to the familiarity threat. The fact that your partner is a manager in the business may bias your thinking on some or all of the issues you encounter. You should not be involved in the audit of this client.

In all of the above situations it could be seen to be a breach of the public interest and professional behaviour.

2.46 Corporations and social responsibility

A corporation is an artificial entity. Discuss whether the rights of this artificial entity should ever take priority over the rights of individuals and communities.

There is not necessarily a ‘right’ answer to this question. Everyone will have their opinion and arguments to support such opinions. Discussion could include the following.

* A corporation does not physically exist and cannot think or act without humans acting as agents. They are creations of the state and have evolved over time to the form that they take today. How they should be allowed to evolve is linked to what their role is and this varies depending on one’s social stance.
* A corporation’s existence comes about because the laws of its jurisdiction allow this. The laws can add rights and responsibilities and take them away.
* Some students may argue that individual rights should take priority over the rights of the corporation and would regard it as objectionable to think otherwise. Others may argue there should be less government regulation and therefore more rights for corporations. The rest may just accept that is the way corporations and business have evolved and that not much can be done to change this.
* To help the discussion maybe an example could be introduced. One from the local area or from current media. For example, should a corporation have a right to use the local water supply before individuals because they can pay more per kilolitre?

**2.47 Ethics**

**Compare and contrast teleological theories and deontological theories. Discuss whether you think these theories have a place in the modern business society.**

Teleological theories are concerned with the consequences of decisions and if the actions result in good consequences then the behaviour is said to be ethical. This raises two issues: (i) what is a desirable consequence and (ii) upon whose judgement is the consequence examined. A number of teleological theories have been proposed the most notable being ethical utilitarianism (also known as consequentialism).

Deontological theories are those concerned with duty. Theological ethics would fall within this theory as it is concerned with the rules to follow according to religion. Another philosophy under this heading is Kantianism.

Teleological theories are to do with consequences whereas Deontological theories are to do with motivation. Both would have a place in the modern business world as examining motivation for action and the consequences of action can help in business decision making.

**2.48 The Australian Accounting Standards Board (AASB) and international accounting standards**

**What is the relationship between the AASB and international standard-setting bodies such as the IASB?**

Since 1 January 2005, Australian entities have complied with Internal Financial Reporting Standards (IFRS). The Australian Accounting Standards Board (AASB) is responsible for the development and maintenance of high-quality financial reporting standards in Australia, and to contribute to the ongoing development of global accounting standards. The AASB provides input into current International Accounting Standards Board (IASB) projects by issuing exposure drafts of amended AASBs that incorporate the relevant clauses and requirements of the IFRS.

**2.49 Ethics, corporate governance and sustainability**

**Underlying the professional code of ethics is an obligation to act in the public interest. Utilitarianism espouses the need to act and make decisions with consequences in mind. Practically, business decisions are often made based on a consideration of the decision’s effect on the business. How can any business manager merge the principles of utilitarianism — acting in the public interest — while ensuring growth and prosperity to the organization they are managing? Discuss.**

To discuss this, a good article is ‘Counting the consequences’ by Eva Tsahuridu, from *IntheBlack Magazine*, March, 2013, p. 71. The article discuses outcomes that help guide behaviour when difficult choices must be made.

**2.50 Corporate governance**

**Corporate governance relates only to large public enterprises and is therefore irrelevant for small business. Discuss this statement.**

All businesses need good governance. Governance is about the distribution of authority within an organisation to make decisions relating to its resources and the use of policies and procedures to ensure proper control and decision making for the accomplishment of aims, goals and strategies as effectively and efficiently as possible.

So governance is as much relevant for a small business as it is for a large one.

Instructors note: a paper written by Sir Adrian Cadbury (author of the Cadbury Report on corporate governance) wrote a paper entitled ‘*Family Firms and their Governance: Creating tomorrow’s company from today’s*’ (Egon Zehnder International, Great Britain, 2000). This may be worth discussing if interest warrants. Generally, the Cadbury Report recommended that a family firm establish a board (through a family council), which should focus on strategic business issues, that there be clear lines of authority, stability and continuity with respect to policy and values. He also recommended including an independent person on the board.

**Problems**

**2.51 Corporate governance**

**The notes to the 2018 consolidated financial statements of JB Hi-Fi Ltd appear in appendix of this book. Examine these notes together with other information from the website (**[**www.jbhifi.com.au**](http://www.jbhifi.com.au)**) to investigate JB-HiFi Ltd’s compliance with principle 4 (safeguard the integrity of financial reporting) of the ASXCGC Corporate governance principles and recommendations.**

**Form teams to investigate the recommendations under principle 4 as presented in this chapter. The teams should examine one different recommendation each.**

The recommendations under principle 4 of the ASX guidelines for good corporate governance are listed below together with the relevant information from the JB Hi Fi Limited Annual Report 2018.

Recommendation 4.1

*The board of a listed entity should:*

*(a) have an audit committee which:*

*(1) has at least three members, all of whom are non-executive directors and a majority of whom are independent directors; and   
(2) is chaired by an independent director, who is not the chair of the board,   
and disclose:   
(3) the charter of the committee;   
(4) the relevant qualifications and experience of the members of the committee; and   
(5) in relation to each reporting period the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or*

*(b) if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its corporate reporting, including the processes for the appointment and removal of the external auditor and the rotation of the audit engagement partner.*

* Page 3 of the JB Hi-Fi Ltd Preliminary Annual Report discusses the Audit and Risk management committee. So JB Hi-Fi has established an audit committee.
* Page 3 of the JB Hi-Fi Annual Report indicates that The Audit and Risk management committee comprises non-executive directors all of whom are independent with relevant financial, commercial and risk management experience and an independent chairperson who is not the chairperson of the Board.
* Page 3 states that the committee has a formal charter. This can be found on their website.
* Pages 12 to 15 contain information about the audit committee members’ qualifications and the number of meetings held and attendance.

*Recommendation 4.2*

*The board of a listed entity should, before it approves the entity’s financial statements for a financial period, receive from its CEO and CFO a declaration that, in their opinion, the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity and that the opinion has been formed on the basis of a sound system of risk management and internal control which is operating effectively.*

* Page 53 of the JB Hi-Fi Ltd Annual Report contains the CEO and CFO declaration that in their opinion the financial records have been properly maintained, comply with reporting standards and present a true and fair view of the financial position.

*Recommendation 4.3*

*A listed entity that has an AGM should ensure that its external auditor attends its AGM and is available to answer questions from security holders relevant to the audit.*

* *The preliminary report does not state whether the auditor will attend the AGM.* There is no indication that the auditor will not be available. *The audit report is presented on pages 47–52.* An independent external auditor helps promote the integrity of the financial system and is key in providing the public with confidence.

**2.52 Ethics**

**Erle Smith is a financial controller with Accounting Success Ltd, an entity that sells software products to accounting firms and small businesses. At present, Erle is analysing a number of software packages that focus on job costing. He needs to pick one package that he can recommend to his clients. Each software vendor is keen to have their software selected as it will result in a significant increase in sales for their company.**

**Anitah Loh is a salesperson for software company Catta Ltd. She has told Erle that he should go to Tokyo to analyse her company’s software package properly, because the programming experts there could give him a thorough demonstration. Anitah has also suggested that he take his family, so that he feels relaxed in a foreign country and is in the right frame of mind to undertake his analysis. She says that Disneyland is worth visiting. Catta Ltd would pick up the expenses for the trip.**

**Required**

**a. Do you think Erle should take the trip? Outline any ethical concerns involved.**

**b. Do you think the management of Accounting Success Ltd should allow Erle to go on the trip?**

**c. Do you think that Accounting Success Ltd should have a code of conduct? What would be the advantages and disadvantages to Accounting Success Ltd of having a code of conduct?**

a. The main ethical concerns are independence, integrity and objectivity. The facts seem to indicate that it is an all-expenses paid trip to Tokyo for Erle and his family. This could give the impression that the trip is a gift that could influence the software chosen. When making the software decision, Erle may feel obligated to Catta Ltd because of the trip. From a third party viewpoint, there could appear to be a conflict of interest and a lack of independence. On the other hand, it would be a great opportunity to gather more information about the software. There could be an opportunity to meet users of the software, to hear clearly what the future development plans of the software are and it would save Accounting Success Ltd money as they wouldn’t have to pay for the trip. However, overall, the suggestion of taking family and of having a trip to Disneyland seems to indicate that the trip is more of a gift. The appearance to third parties and the impact on independence, integrity and objectivity may be too great. I would advise Erle not to take the trip.

b. The trip would save Accounting Success Ltd money and it would help gather information that could be useful in making a purchase decision. However, there are the ethical considerations as discussed in part (a) and the effect the trip would have on other employees and other software vendors. Maybe Accounting Success Ltd could set some conditions to enable an employee to travel to Tokyo to gather information without having the appearance of favouring Catta Ltd Conditions could include:

* the family does not travel
* the time spent in Tokyo is only dedicated to the task at hand
* an employee other than Erle travel to gather the information so there is a separation of the decision maker from the all-expenses paid trip.

Given the conditions above, Accounting Success Ltd could allow the trip to take place without unduly compromising any ethical code.

c. Yes, it is probably worthwhile for the company to develop its own code of conduct. The advantages are that it would send a message to employees about acceptable behaviour and help promote an aura of trust and credibility around business dealings. It would strengthen the professionalism of the company and even help the management team to foresee any ethical dilemmas. The disadvantages are that a code can’t possibly cover all situations and employees may think that it sets down the minimum standard and it could be costly and time-consuming to develop.

**2.53 Business sustainability and ethics**

**Search the Johnson & Johnson website for their famous credo http://www.jnj.com.au. *Hint:* Access the credo from the drop-down menu called ‘Our Company’). Given that the credo was written nearly 60 years ago, comment on its appropriateness in today’s business world. Further, reflect on the early philosophical writings (such as utilitarianism and Kantianism) and comment on the credo’s relevance to these philosophies.**

The Johnson & Johnson credo lists all stakeholders as important to the mission of the enterprise. This reflects well with today’s stakeholder philosophy. Further, it has been discussed that the philosophies of companies such as Johnson & Johnson, Cadbury, Du Pont and other companies that started in the early twentieth century were such that they considered and believed in community and the benevolence of people. It was only in the latter part of the twentieth century that the management of firms took the self-interest principle to the next level. Even Freidman and Smith, advocates of this principle, believed that there were ‘rules to the game’. With credos such as Johnson & Johnson there may not be a need for excessive regulation.

**2.54 Ethics**

**The downturn in the economy during 2008 revealed one of the biggest cases of fraud in history. The fraud was masterminded by Bernie Madoff, a well-known American finance executive. The $65 billion Ponzi scheme called the Bernard L Madoff Investment Securities resulted in a number of institutional and high-wealth individuals losing their money. Clients affected included Steven Spielberg, HSBC, Fortis, RBS, Baroness Thyssen-Bornemisza, Yeshiva University, top Merrill Lynch executives and Eliot Spitzer, the New York governor. Many charities and organisations have had to shut down due to losing their money. There were also various fund managers who channelled their clients’ money into the Madoff Investment. One French fund manager committed suicide when the extent of the disaster became known.**

**It seems that there were warning signals and general rumours over the years that Bernie’s investment performance was too good to be true. The performance of the investment fund was never over the top but was consistently good. One investor even tried to re-engineer the investment strategy by calculating each individual trade but couldn’t get the same investment return. He decided it just didn’t add up and that something had to be wrong. The fact that there was never a down month, that he had his own broker-dealer clearing trades, that a relative was his finance person, that the regulatory audit was performed by a too-small audit firm (it employed three people, including an 80-year-old), that he didn’t welcome questions and returned funds to investors who probed too much were all signs that something may be too good to be true. The market’s collapse in 2008 exposed the truth that the consistently good 6.8 per cent returns were being funded by fresh investments from new clients.**

**It seems people invested because Bernie was ‘a good bloke’. They trusted him. He wasn’t a loudmouth, he belonged to the right clubs, he had the right connections and he seemed to perform consistently. Despite complaints and concerns about the business since 2000, and a number of discrepancies found by a Securities Exchange Commission (SEC) lawyer and inspector in 2004, the SEC did nothing.**

**On 29 June 2009, Bernard Madoff was sentenced to 150 years in prison. His statement: ‘I have left a legacy of shame, as some of my victims have pointed out, to my family and my grandchildren. This is something I will live in for the rest of my life. I’m sorry.’ (Compiled from various Clusterstock.com, nydailynews.com and Cityfile New York articles.)**

**Some fund managers invested and lost clients’ money in the Bernard L Madoff Investment Securities scheme. One example was that of the Fairfield Greenwich Group that directed US$7.3 billion of client money into the fund over a five-year period.**

**Required**

**(a) If you were a client of Fairfield Greenwich Group, what minimum checks on recommended investments would you have expected your fund management to undertake?**

**(b) As a client, do you think you should be made aware if your fund manager or financial planner would gain a commission from your investment? Why or why not?**

**(c) If you on the advice of your financial planner, invested your money in the Bernard L Madoff Investment Securities scheme and then subsequently lost it, would you blame your financial advisor given that it was a well-orchestrated fraud? Why or why not?**

**(d) Would your answer in (c) be different, if you knew that the Fairfield Greenwich Group earned $US500 million in commissions by directing the $US7.3 million capital into the fund?**

a. As a client, you go to financial advisors for expertise in the financial area. You may not understand some of the complexity of the market but at a minimum you would expect that your advisor to do fundamental checks on investments and assess for themselves the level of risk.

b. Yes, you should be made aware of all fees and charges that your fund manager or financial planner would gain from your investments. The confidence that you place in your financial advisor is based on trust. Trust in their knowledge, trust in their integrity and trust in their honesty.

c. Despite the checks and balances that your financial advisor performed, if there is a well-orchestrated fraud then it may be impossible for anyone to be aware of it. Bernie Madoff had started his investment scheme in the 1960, he held numerous positions on government bodies and committees, he had consistent performance — never high or low and most others in the investment world rated his scheme low risk. So as a client is that enough? You may feel that despite all this your advisor should have understood the type of investment and the risk that it carried.

d. Given the level of fees, the clients should have expected their advisors to vouch for the legitimacy of the investment. Further, to take fees for investing signals some independence issues.

**Decision-making activities**

**2.55 Corporate Governance and the Royal Commission**

**The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established in 2017.**

**There were 10 140 public submissions made mainly in the areas of personal financial, superannuation and small-business finance. A number of entities were asked to provide the Commission with information concerning instances of misconduct or conduct falling below community standards and expectations that the entity had identified in the past 10 years.**

**Required**

**Go to the Royal Commission website at:** <https://financialservices.royalcommission.gov.au/Pages/default.aspx>

**1. Select ‘Submissions’.**

**2. Select ‘Submissions in response to original request’.**

**3. Choose one of the companies that have been asked to provide further information.**

**4. Describe one instance of misconduct or conduct falling below community standards that has been identified for that company.**

**5. What has the company done recently to rectify the situation?**

**6. Do you think that the company has resolved the issue? Explain why or why not.**

*Instructor’s note*: students’ answers will vary depending on which instance they have chosen to investigate. The example below refers to NAB dated 29 January 2018.

One area of concern related to adviser service fees (ASF) being incorrectly charged to customers (item 11) without the provision of services (primarily retail customers) between 2008 and 2015. It is estimated that approximately 25 000 customers were affected and approximately $6.6 million in fees were charged.

NAB is in the process of remediating those affected and they continue to engage with the ASIC on these ASF breaches. NAB Group has implemented controls that are required to ensure obligations owed to customers in respect of ASF are delivered, including:

* assignment of accountability for ensuring controls are adhered to on a day to day basis
* adoption of simpler standards for advisers and internal employees to apply
* a monitoring and supervision uplift program addressing issues raised by ASIC, which includes a focus on improving controls around ongoing provision of services to customers.

It would appear that the issue has been resolved through the remediation to those affected by these charges and the implementation of controls to ensure customers are provided the services for which they are charged in the future.

**2.56 Ethics and the Royal Commission**

**Required**

**Go to the Royal Commission website at:** [**https://financialservices.royalcommission.gov.au/Pages/default.aspx**](https://financialservices.royalcommission.gov.au/Pages/default.aspx)

**1. Select ‘Submissions’.**

**2. Select ‘Submissions in response to original request’.**

**3. Choose one of the companies that have been asked to provide further information.**

**4. Following Langenderfer and Rockness (1990), determine the facts of the case against this company.**

**5. Determine the ethical issues in the case.**

**6. Determine the norms, principles and values related to the case.**

*Instructor’s note*: students’ answers will vary depending on which instance they have chosen to investigate. The example below refers to NAB dated 29 January 2018.

**4.Determine the facts of the case.**

NAB Group incorrectly charged customers adviser service fees (ASF) without the provision of services (primarily retail customers) between 2008 and 2015. It is estimated that approximately 25 000 customers were affected and approximately $6.6 million in fees were charged.

**5. Determine the ethical issues in the case.**

Misconduct due to ASFs being charged when services not provided. There is a duty to:

* ensure clients are not charged for advice when none is given
* ensure internal controls are implemented to prevent and/or detect inappropriate charges to customers
* abide by the code of ethics — integrity, professional competence and due care and professional behaviour.

1. **Determine the norms, principles and values related to the case.**

* Integrity — NAB Group advisers were not straightforward, honest and sincere in their approach to professional work (i.e. charged customers for adviser service fees when no advice was given).
* Professional competence and due care — NAB Group did not carry out professional work in accordance with technical and professional standards relevant to advisers. Due care, competence and diligence was lacking as ASFs were charged when services were not provided. It shows internal controls were inadequate to prevent or detect this misconduct.
* Professional behaviour — NAB Group advisers did not conduct themselves in a manner consistent with the good reputation of the profession which led to discredit to the profession.

**2.57 Revised *Conceptual Framework***

**The IASB has published its revised *Conceptual Framework for Financial Reporting*.**

**Required**

**Go to the IFRS website and select the ‘Project Summary’ for the *Conceptual Framework* at:** [**https://www.ifrs.org/projects/2018/conceptual-framework/#supporting-material**](https://www.ifrs.org/projects/2018/conceptual-framework/#supporting-material)**.**

1. **Why was the *Conceptual Framework* revised?**
2. **Summarise the main changes.**
3. **Choose two chapters and comment on the specific changes to these chapters.**
4. **Why was the *Conceptual Framework* revised?**

The *Conceptual Framework* (CF) was revised to improve financial reporting by providing the IASB with a complete and updated set of concepts to use when it develops or revises IFRSs. The IASB wanted to improve the CF because:

* some important areas were not covered (e.g. little guidance on measurement, presentation and disclosure was provided)
* some parts were out of date and failed to reflect the current thinking of the IASB and some other parts were unclear and less helpful than they could be.

1. **Summarise the main changes.**

Main changes to the revised CF include the following.

* Introduced measurement concepts, including factors to be considered when selecting a measurement basis.
* Introduced presentation and disclosure concepts, including when to classify income and expenses in other comprehensive income.
* Introduced guidance on when assets and liabilities are removed from financial statements (derecognition).
* Updated the definitions of assets and liabilities.
* Updated the recognition criteria for including assets and liabilities in financial statements.
* Clarified prudence, stewardship, measurement uncertainty and substance over form.

1. **Choose two chapters and comment on the specific changes to these chapters.**

Instructor’s note: students’ answers will vary depending on the two chapters they have selected; thereby, providing an opportunity for classroom discussion. The chapters and a brief overview of their changes are as follows.

* + - 1. The objective of financial reporting — clarified why information used in assessing stewardship is needed to achieve the objective of financial reporting.
      2. Qualitative characteristics of useful financial information — clarified the roles of prudence, measurement uncertainty and substance over form in assessing whether information is useful.
      3. Financial statements and the reporting entity — new chapter — it describes the objective and scope of financial statements and provides a description of the reporting entity.
      4. The elements of financial statements — refined the definitions of an asset and a liability and updated the definitions of income and expenses to reflect this.
      5. Recognition and derecognition — revised the recognition criteria for including assets and liabilities in financial statements and provides guidance on when to remove them (derecognition). The revised recognition criteria refer explicitly to the qualitative characteristics of useful information.
      6. Measurement — describes what information measurement bases provide and explains the factors to consider when selecting a measurement basis. The previous CF included little guidance on measurement.
      7. Presentation and disclosure — new chapter — covers concepts on presentation and disclosure and guidance on including income and expenses in the statement of profit or loss and other comprehensive income.

1. Kant, I. 1964. *Groundwork of the Metaphysic of Morals*; trasl Paton, H. J., Harper and Row, London as cited in Chryssides, G. D. & Kaler, J. H. 1995, Ethical theory, chapter 3, *An introduction to business ethics*, Chapman & Hall, London, pp. 80–107. [↑](#footnote-ref-1)