Amalgamation

Introduction

- A Company in order to expand or become more profitable may decide to merge or may absorb another company.
  In an "Amalgamation", two or more than two co.'s are combined into one by "Merger" (or) by one "Taking over" the other co. Hence the term , Amalgamation means two kinds of activities :-
  a) Two or more than two co. join together to form a new company.
  b) Absorption or blending of one company by the other. Therefore ,Amalgamation includes Absorption.

- In an Amalgamation , there is a sale and a purchase taking place. Hence, the books of the Selling co. must be closed and the books of Purchasing Co. must be opened.
- -Transferor Co. means the Selling Co
- -Transferee Co. means the Purchasing Co

Types of Amalgamations

- As per Accounting Standards AS 14 there can be Two types of Amalgamations:-
- Amalgamation in the Nature of “Merger”
- Amalgamation in the Nature of “Purchase”

Amalgamation in the Nature of Merger

- An Amalgamation in the nature of merger should be considered when ALL the FIVE following conditions are satisfied.
- 1) All the Assets & Liabilities of the selling company become AFTER Amalgamation, the Assets & Liabilities of the Transferee co.(p.co.)

- 2) No Adjustment is intended to be made in the books value of Assets & Liabilities of the Selling co. when they are incorporated in the books of purchasing co.
- 3) Shareholders holding 90% of the face value of the equity shares of the selling co. become the equity shareholders of the purchasing co.

- 4) The Purchase consideration for Amalgamation is discharged by the purchasing co. wholly by the issue of Equity Shares.
- 5) The Business of the Transferor co. is intended to be carried on after the Amalgamation by the Transferee co.

Amalgamation in the Nature of Purchase

- If any one (or) more of the above five conditions are not satisfied in an Amalgamation , such an Amalgamation is called Amalgamation in the Nature of Purchase.

Methods of Accounting

- **Pooling of Interest Method :- (Merger**)
- Under this method ,the Assets, Liabilities & Reserves of the selling co. will be taken over by the purchasing co. at their existing values.

- **Purchase Method:- (Purchase Amalgamation)**
- Under this method, the Assets & Liabilities of the Selling co. are taken over at their Re-Valued figures in the books of Purchasing co. Hence, the Reserves of the Selling co. should not be taken in the books of the Purchasing co.

- Note:- If there are any Statutory Reserves (Eg: Foreign Project Reserve,Export Profit Reserve, Development Allowance Reserve)-then it is taken over by the purchasing co.

Steps in Accounting

- 1. Calculation of Purchasing Consideration.
- 2. Closing Entries in the books of Selling co.
- 3. Opening Entries in the books of Purchasing co.
- New Balance Sheet in the books of Purchasing Co.

Purchase Consideration

- As per AS 14 , Purchase consideration means the price payable by the Purchasing co. to the shareholders of the Selling co. for the Business taken over by the Purchasing co.

Calculation of Purchase Consideration

- Purchase consideration can be calculated under the following Four Methods.
- 1.Lumpsum Method
- 2.Net Assets Method
- 3.Net Payment Method
- 4.Shares Exchange or Intrinsic value
-   Method.

Lumpsum Method

- In this method, total purchase consideration payable by the Purchasing co. to the Selling co. is directly given as a Lumpsum amount.

Net Assets Method

- In this case, the purchase consideration will be the Excess of Assets over Liabilities taken over by the purchasing co. at agreed value.
- Assets taken over at agreed value
- (excluding fictitious Assets)
- Less:-
- Liabilities taken over at agreed value
- (excluding shareholders fund)

- **Under the Net Assets Method ,the following points must be noted regarding the Assets & Liabilities taken over:-**
- 1.Assets include cash,Bank, Goodwill and Prepaid Expenses.
- 2.Assets will never include Miscellaneous expenditure.
- 3.Any Asset not taken over do not include while calculating p.c.
- 4All Assets of Selling Co. should be taken at revalued figures

Liabilities:-

- Take only Liabilities Taken over and at their agreed values.
- Liabilities will never include shareholders funds(i.e)share capital, reserves,accumulated profits.
- Profits and reserves:- P&la/c,generalreserve,capitalreserve,sinking fund,capital redemption fund,sharepremium,dividend equalisationfund.

- Liabilities will include Trade Liabilities and Liabilities to third parties
- Note:- Trade liabilities means creditors,B/P.
- 3rd Party liabilities-Bank O.D,Debentures,O/Exp,TaxLiabilities,
- S.P.F,Employees profit sharing fund,Workmens comp fund(extent of liabilities)

Net Payments Payment Method

- Total up ALL payments made by the purchasing co,to the shareholders of the selling co.
- To equity shareholders of s.co.
- To Preference shareholders of s.co.
- Note:-when all payments are given clearly do not take into a/c Assets &liabilities

- Payments to debenture holders, creditors,any other party of selling co. and Liquidation exp of s.co. paid by p.co. :- should not be included while calculating purchase consideration.

Share exchange or Intrinsic value Method

- Purchase consideration is ascertained on the basis of the ratio in which the shares of P.co. are to be exchanged for the shares of the s.co.This Exchange Ratio is generally determined on the basis of the value of each company's shares.

Closing entries in the books of s.co.

- Realisation a/c must be opened:- transfer all Assets except fictitious assets and Liabilities taken over by p.co. must be transferred.
- Liabilities not taken over to be paid off by the s.co.
- Shareholders funds and fictitious assets transfer to Equity shareholders a/c.

Balance sheet

- Liabilities
- Preference s/c to preference s/h a/c
- Equity s/c & reserves to eq s/h a/c
- Debentures&other liabilities to Realisation a/c(if taken over by p.co.)

- Assets
- fixed assets
- Intangible assets
- Investments
- Current assets to
- Realisation a/c
- Fictitious assets to s/h a/c.

Notes to remember

- 1.Always transfer all the above items at B/S values.
- 2.If any liability not taken over by p.co.:-
- A)Debentures to deb/holders.
- B)Other liabilities not taken over by p.co. (open that ledger a/c with B/S values) C) cash not taken over (open that ledger a/c)

UNIT IV
AMALGAMATION

Amalgamation is defined as the combination of one or more companies into a new entity. It includes:

i. Two or more companies join to form a new company
ii. Absorption or blending of one by the other

Thereby, amalgamation includes absorption.

However, one should remember that Amalgamation as its name suggests, is nothing but two companies becoming one. On the other hand, Absorption is the process in which the one powerful company takes control over the weaker company.

Generally, Amalgamation is done between two or more companies engaged in the same line of activity or has some synergy in their operations. Again the companies may also combine for diversification of activities or for expansion of services

Transfer or Company means the company which is amalgamated into another company; while Transfer Company means the company into which the transfer or company is amalgamated.

Existing companies A and B are wound up and a new company C is formed to take over the businesses of A and B	Amalgamation
Existing company A takes over the business of another existing company B which is wound up	Absorption
A New Company X is formed to take over the business of an existing company Y which is wound up.	External reconstruction

TYPES OF AMALGAMATION

Amalgamation in the nature of merger:

In this type of amalgamation, not only is the pooling of assets and liabilities is done but also of the shareholders' interests and the businesses of these companies. In other words, all assets and liabilities of the transferor company become that of the transfer company. In this case, the business of the transfer or company is intended to be carried on after the amalgamation. There are no adjustments intended to be made to the book values. The other conditions that need to be fulfilled include that the shareholders of the vendor company holding atleast 90% face value of equity shares become the shareholders' of the vendee company.

i. **Amalgamation in the nature of purchase:**

This method is considered when the conditions for the amalgamation in the nature of merger are not satisfied. Through this method, one company is acquired by another, and thereby the shareholders' of the company which is acquired normally do not continue to have proportionate share in the equity of the combined company or the business of the company which is acquired is generally not intended to be continued.

If the purchase consideration exceeds the net assets value then the excess amount is recorded as the goodwill, while if it is less than the net assets value it is recorded as the capital reserves.

NEED OF AMALGAMATION

a. To acquire cash resources
b. Eliminate competition
c. Tax savings
d. Economies of large scale operations
e. Increase shareholders value
f. To reduce the degree of risk by diversification
g. Managerial effectiveness
h. To achieve growth and gain financially

ACCOUNTING OF AMALGAMATION :

A. **Pooling of Interests Method:**

Through this accounting method, the assets, liabilities and reserves of the transfer or company are recorded by the transferee company at their existing carrying amounts.

B. **Purchase Method:**

In this method, the transfer company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual assets and liabilities of the transfer or company on the basis of their fair values at the date of amalgamation.

Computation of purchase consideration:

For computing purchase consideration, generally two methods are used:

1. Purchase Consideration using net asset method: Total of assets taken over and this should be at fair values minus liabilities that are taken over at the agreed amounts.

Particulars	Rs.
Agreed value of assets taken over	XXX
Less: Agreed value of liabilities taken over	XXX
Purchase Consideration	XXX

Agreed value means the amount at which the transfer or company has agreed to sell and the transferee company has agreed to take over a particular asset or liability.

Purchase consideration using payments method:

Total of consideration paid to both equity and preference shareholders in various forms.

Advantages of Amalgamation

- Competition between the companies gets eliminated
- R&D facilities are increased
- Operating cost can be reduced
- Stability in the prices of the goods is maintained

Disadvantages of Amalgamation

- Amalgamation may lead to elimination of healthy competition
- Reduction of employees may take place
- There could be additional debt to pay
- Business combination could lead to monopoly in the market, which is not always positive

The goodwill and identity of the old company is lost

UNIT V

INTERNAL RECONSTRUCTION

Meaning

It is an arrangement made by the companies whereby the claims of shareholders, debenture holders, creditors and other liabilities are altered/ reduced, so that the accumulated loss are written off, asset are valued at its fair value and the balance sheet shows the true and fair view of the financial statement

Forms of internal reconstruction

i. Re-organization or alteration of share capital

ii. Reduction of share capital and other liabilities

Objectives of internal reconstruction

i. To resolve the problem of over-capitalization/ huge accumulated losses/ over valuation of assets

ii. When the capital structure of a company is complex and is required to make it simple

iii. When change is required in the face value of shares of the company

Meaning of capital reduction account

It involves sacrifice on the part of shareholders, debenture holders and creditors. The amount sacrificed by them shall be utilized in writing off of losses and to bring down the assets to their real values. An account called capital Reduction also called Internal Reconstruction Account or capital Reorganization Account is opened for this purpose. Amounts sacrificed by various parties are credited to this account. It is generally resorted to write of the past accumulated losses of the company .

BASISFOR COMPARISON INTERNAL RECONSTRUCTION EXTERNAL RECONSTRUCTION

INTERNAL RECONSTRUCTION	**EXTERNAL RECONSTRUCTION**
Internal reconstruction refers to the method of corporate restructuring wherein existing company is not liquidated to form a new one	External reconstruction is one in which the company undergoing reconstruction is liquidated to take over the business of existing New company
No new company is formed	New company is formed
Balance Sheet of the company contains "And Reduced"	No specific terms are used in the Balance sheet
Capital is reduced and the external liability holders waive their claims	No reduction in the capital
No such transfer takes place	Assets and liabilities of existing company are transferred to the new company
Approval of court is must	No approval of court is required

1.BANK ACCOUNTS

A bank account is a financial account maintained by a bank for a customer. A bank account can be a deposit account, a card account, a current account, or any other type of account offered by a financial institution, and represents the funds that a customer has entrusted to the financial institution and from which the customer can make withdrawals. Alternatively, accounts may be loan accounts in which case the customer owes money to the financial institution.

BOOKS MAINTAINED BY BANK :

Cash Book:

For recording different types of cash transactions two types of cash books are recorded, viz
(I) Rough Cash Book which deals with cash receipts and cash payments maintained by a receiving cashier and paying cashier, respectively.

Day Book:

- It records day-to-day transactions of the book relating to cash transfers, clearings etc. Besides the above, Received Waste Book, Sectional Cash Book etc. are also to be maintained.
- It records serial number, depositor’s name, amount received etc. in cash, whereas, in case of cash payment, serial number, payee’s name, amount paid, number of token etc. are recorded,

(ii) A Fair Cash Book, on the other hand, is one when a separate person, after receiving the above information from the paying and receiving cashier, records the transactions in a separate book. Naturally, the transaction of the fair cash book must tally with the sum total of the above two rough cash books.

Current Account Ledger:

It records the transactions of those customers who open current account. Generally, the bank does not pay interest on the balance of this account but a nominal charge is taken by the bank for rendering the services. If there are many current accounts, those are to be serially numbered.

Savings Bank Ledger:

It records the transactions of those customers who open savings account in a bank. The detailed description of the customer, viz., name, address, occupation, are recorded along with an account number. If there are many Savings Account ledgers, they are to be serially numbered.

Fixed Deposit Ledger:

It contains transactions of those customers who have deposited their money into the bank for a fixed period. Generally, at the top of the account, depositor's name and address, rates of interest, period of deposit, the amount so deposited etc. are to be recorded.

General Ledger:

It is actually the key ledger of the accounting system of a bank. It contains a total amount in respect of total Current Accounts, total Savings Bank Account, total Loans Account, total Bills Payable Account, total Expenses and total Revenue Accounts. Each ledger is kept under self-balancing system. A trial balance can easily be prepared which helps to prepare the final account as Well.

Register Section:

The register section includes:

Bills for Collection Register, Securities Register, Document Register, Standing Order Register, Cheques Dishonored Register, Drafts Issue Register, Drafts Payable Register, D.D. Register, Foreign Letters of Credit Register etc.

Concept of Slip System:

It is a method of rapid posting in books maintained under Double Entry principle. Under this system, posting is done from slips and not from journals or cash books.

Slips are loose leaves of journals and these are supplied either by the customers or by the bank staff.

It becomes necessary for a bank to know the position of its individual customer's account at any time and to see that the transactions are recorded as soon as they take place.

The same is not actually possible if transactions are recorded in bound books. So, original cheques and paying-in-slips are used as vouchers. Consequently, the cashier, for this purpose, credits cash account for receiving cheques and it passes on to the ledger-keeper concerned for debiting the customers' accounts.

On the contrary, for paying-in-slips, the cashier debits cash account and passes on the same to the ledger-keeper concerned, for crediting the customers' accounts. In this way, the Double Entry posting is completed. The transactions which are not covered by original slips are posted by means of 'dockets' which are made out by the bank staff. These are used for posting purposes.

Advantages of Slip System:

The advantages of this system are:

I) it reduces the possibility of errors and frauds;

(ii) it saves a lot of time since it is prepared by the customers themselves;

(iii) it provides a good system of internal check etc.

Disadvantages of Slip System:

The system is also not free from snags. It suffers from the risk of loss, misappropriation or destruction of slips since they are loose.

Unit IV

Valuation of Goodwill

Meaning of goodwill:

According to Spicer and Pegler goodwill is defined as, “goodwill is said to be that element rising from the reputation, connection or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business.”

Thus goodwill is the value of the reputation of the concern, it consists the benefits a business enjoys in connection with its customer, employees and other third party. It is also said that, “goodwill is the present value of a firm’s anticipating excess earning.”

Goodwill may be described as extra saleable value attaching to a prosperous business beyond the intrinsic worth of the net assets. Being of the nature of extra value or advantage, it is considered as an intangible asset like patents, trademarks and copyrights. It is not a fictitious asset.

Features of Goodwill

1.· Goodwill has no physical existence.

2.Goodwill is an intangible asset.

3. Only for a going concern business goodwill is relevant.

4. Goodwill has the ability to generate additional income for the business firm like any other asset.

5. Goodwill of a firm represents the excess of real net worth of assets over their book value.

6. It is attached with the firm and cannot be isolated from the business. It cannot be realised (sold) separately

Factors determining the value of goodwill

1. Nature of business. It means the prevailing competition, level of risk involved, govt. Regulations, nature of demands etc. If the existing business units are earning more than normal profits and have secured monopolistic position, they will be enjoying more goodwill.

2**. Favourable location**. It is very well known that certain cities or places are most suitable for particular industries, business having units falling under same areas can enjoy the goodwill by selling more products. It must be noted that goodwill arises in a particular locality only because shopping space is limited in relation to demand for it.

3. **Capital requirements**. Amount of capital required for a business is also influence the value of goodwill. The business requiring less capital can realise higher amount of goodwill than another business earning less profits with a huge amount of capital.

4**. Life of the business**. Time also increases the value of goodwill. Business running on profitable lines for the last many year enjoys more goodwill as compared to the recent started business.

5**. Trade name**. A firm which possesses the necessary patents and trademarks for selling its products will have built up good reputation and enjoys goodwill.

6**. Special contracts**. Where a business is having special contracts in hand giving exceptional profits, the goodwill of the business will be much higher.

7**. Managerial ability**. The efficiency, skill and ability of the managerial personnel is also an important factor on which value of goodwill depends. The efficient management helps in increasing profits in the business which in turn, increases the value of goodwill.

8. **Risk involved in the business**. The value of goodwill is likely to be higher in the low risk business. On the contrary, if the business is purely of speculative nature and is very risky, the goodwill will have very little value.

9**. Profit trends**. When the last year's records of the business shows the constantly increasing profits, it will lead to attract higher value for its goodwill.

10. **Nature and extent of competition**. The value of goodwill of a business is is greatly affected by the degree of competition. If the competition is negligible or if there is no competition, the value of goodwill will be more or vice-versa.

11. **Quality of products**. The business units which enjoys good commercial reputation for the quality of their products, they have a high value of goodwill.

12**. Money market conditions**. When easy money market conditions prevail, there would be more buyers willing to buy an established business and pay a higher price for the goodwill or vice-versa.

13. **Types of customers**. Commercial value of goodwill depends upon the types of customers. They may be classified according to the distinctive features viz. Cat, dog and rat. The valuation will depend upon the degree of attachment of business with personnel character of the owner.

14**. Miscellaneous factors**. Besides these above mentioned factors, the value of goodwill is also affected by employer-employee relation. Technical know-how possessed by the business, future prospects of the industry, research and development efforts, and govt. Policies etc.

Need for valuation of goodwill.

It depends on the form of business organisation.

Sole traders: under the sole traders form of business organisation the need for the valuation of goodwill may arise in the following circumstances:

a. When the business is sold.

b. When a new person is admitted in the firm and the firm becomes a partnership firm.

c. When the business is converted into a company.

Partnership firm: Under the partnership form of business organisation the need for the valuation of goodwill may arise in the following circumstances:

a. When a new partner is admitted to a partnership firm.

b. When an existing partner retires or dies.

c. When there exists any change in the profit sharing ratio of the existing partners.

d. When whole of the partnership firm is sold out to any other firm or person.

e. When a partnership firm is converted into a company.

f. When there is a case of amalgamation of two firms.

Companies: In case of a company, the need for valuation of goodwill may arise in the following circumstances:

a. When there is a situation of amalgamation of two companies.

b. When the business of the company is sold to another existing company.

c. When one class of the shares is converted to another.

d. When a company acquires the controlling interest in the company and becomes a holding company.

e. When there arises a need for the valuation of the shares of the company.

f. When shares of the company are not listed on the stock exchange and they have to be valued for taxation purposes.

Classification of Goodwill

Goodwill is classified into two categories viz.

1. Purchased goodwill

2. Non purchased goodwill or raised goodwill

Purchased goodwill: This type of goodwill arises only when a business enterprise is acquired by another business enterprise and the price paid is more than the net asset acquired, such goodwill is recognised by the accounting profession and is also shown in the balance sheet.

Methods of valuation of goodwill

1**. Arbitrary assessment method**. The value of goodwill under this method is arrived at by mutual agreement b/w the vendor of a business and its buyer. The amount agreed to be payable for goodwill is the excess of purchase price over the net assets taken over. For example, A ltd. purchases the business of B ltd. and it is mutually agreed upon that A ltd. will pay to B ltd. a sum of Rs. 5,00,000 on account of goodwill.

Although very simple, it is not a reliable and scientific method based on a yardstick of performance of business. The value of goodwill being based on future maintenance profits, the earning capacity of business must be considered while valuing goodwill. If formation regarding earning capacity is not available, this method cannot be used.

2. **Average profits method**. Under this method, goodwill is valued as under:

Goodwill = average profit X no. Of years of purchase

In this case profit means future expected trading profit.

For this purpose following adjustments are to be done:

Balance of profit and loss

Add: (i) all abnormal losses (if already debited)

Like loss by fire or theft, loss on sale of

Fixed assets.

Less: (i) all abnormal incomes (if already credited)

Like insurance claim income from lottery or speculation, profit on sale of fixed assets.

(ii) Non-trading incomes, like income from investment (non-trade), rent from building let out

(iii) normal expenses (if not already debited)

Adjusted trading profit

Average profit may be calculated as

(i**) Simple averages**

Simple average = total profits of some years/no. Of years.

Weighted profit = total of products of profits & weights/total of weights.

Under this method, goodwill is valued on basis of an agreed no. Of year's purchase of the average adjusted profit. The number of years selected depends upon the probable maintenance of past profit in future years.

3. **Super profits methods**. It is the excess of the average profits over the normal profits based on normal rate of return for representative firm in industry. For computation of super profit, the following three factors are required.

A. Normal rate of return.

B. Capital employed

C. Normal profit

Where capital employed = fixed assets + trade investments + current assets – debentures – current liabilities.

Or

Paid up equity and preference share capital + accumulated balance on capital reserves, general reserves and credit balance in profit and loss revaluation profits or loss – fictitious assets – non assets.

Goodwill under super average method

Goodwill = super profit x no. Of years purchase

Where super profit = average adjusted profit – normal profit

Normal profit = capital employed x normal rate of return

4. **Annuity method**. Under this method the value of goodwill is calculated by finding the present worth of an annuity paying the super profit (per year) over the estimated period discounted at the appropriate rate of interest.

Goodwill = super profits x value of an annuity.

Mostly the value of annuity at the normal rate of profit and is same for number of years for which purchase of super profit method is to be applied is given. If in case of the value of annuity is not given the same is calculated by applying the formula

5. **Capitalisation method**. There are two methods of calculation of goodwill under “capitalisation method”, viz.

a. Capitalisation of average trading profit: under this method normal capital employed is be found out by capitalising average trading profit. Normal capital employed means the amount of capital must be invested in the same class of business to earn such average trading profit. But if actual capital employed is less than the normal capital employed, then such difference will be the goodwill of the firm.

b. Capitalisation of super profit: in this case goodwill is calculated by capitalising the super profit at the normal rate of return. This method attempt to determine the amount of capital needed for earning super profit. Under this method,

Goodwill = super profit x 100/normal rate of return.

Following are some of the main features of purchased goodwill:

a. It arises only when there is a purchase of business from one party to another.

b. It is reflected by the purchase transaction.

c. Its cost could depend upon the future maintainable profits.

d. It can be shown in the asset side of the balance sheet in the books of accounts at the end of the financial year.

Non-purchased goodwill: It is also known as “raised goodwill” being no cost is paid for acquiring this goodwill. This goodwill arises only when a business generates its own goodwill over a period of time. The value of raised goodwill depend upon the various factors such as favourable location life time of business, trade mark and patent right special contracts etc.

The main features of such goodwill are:

1. It is internally generated.

2. No cost is placed for it.

3. It is not reflected by a purchase consideration.

4. It is not shown in the balance sheet.

5. Value of goodwill is based on the subjective judgement of the valuer.

Valuation of Shares

In the cases of shares quoted in the recognised Stock Exchanges, the prices quoted in the Stock Exchanges are generally taken as the basis of valuation of those shares. However, the Stock Exchange prices are determined generally on the demand-supply position of the shares and on business cycle.

The London Stock Exchange opines that the Stock Exchange may be linked to a scientific recording instrument which registers not its own actions and options but the actions and options of private institutional investors all over the country/world. These actions and options are the result of fear, guesswork, intelligent or otherwise, good or bad investment policy and many other considerations.

The quotations what result definitely do not represent valuation of a company by reference to its assets and its earning potential.

Therefore, the accountants are called upon to value the shares by following the other methods.

The value of share of a company depends on so many factors such as:

1. Nature of business.

2. Economic policies of the Government.

3. Demand and supply of shares.

4. Rate of dividend paid.

5. Yield of other related shares in the Stock Exchange, etc.

6. Net worth of the company.

7. Earning capacity.

8. Quoted price of the shares in the stock market.

9. Profits made over a number of years.

10. Dividend paid on the shares over a number of years.

11. Prospects of growth, enhanced earning per share, etc. Need and Purpose of Valuation of Shares

The need for valuation of shares may be felt by any company in the following circumstances:

1. For assessment of Wealth Tax, Estate Duty, Gift Tax, etc.

2. Amalgamations, absorptions, etc.

3. For converting one class of shares to another class.

4. Advancing loans on the security of shares

5. Compensating the shareholders on acquisition of shares by the Government under a scheme of nationalisation.

6. Acquisition of interest of dissenting shareholder under the reconstruction scheme, etc.

Factors Influencing Valuation :

The valuation of shares of a company is based, inter alia, on the following factors:

1. Current stock market price of the shares.

2. Profits earned and dividend paid over the years:

3. Availability of reserves and future prospects of the company.

4. Realisable value of the net assets of the company.

5. Current and deferred liabilities for the company.

6. Age and status of plant and machinery of the company.

7. Net worth of the company.

8. Record of efficiency, integrity and honesty of Board of Directors and other managerial personnel of the company.

9. Quality of top and middle management of the company and their professional competence.
10. Record of performance of the company in financial terms.

Methods of Valuation of Shares Certain methods have come to be recognised for valuation of shares of a company, viz.,

(1) Net assets basis or Intrinsic Value Method

(2) Yield Basis Method or Market Value Method

(3) Fair Value Method

Intrinsic Value Method:

This method is also called as Assets Backing Method, Real Value Method, Balance Sheet Method or Break-up Value Method.

Under this method, the net assets of the company including goodwill and non-trading assets are divided by the number of shares issued to arrive at the value of each share.

If the market value of the assets is available, the same is to be considered and in the absence of such information, the book values of the assets shall be taken as the market value.

While arriving at the net assets, the fictitious assets such as preliminary expenses, the debit balance in the Profit and Loss A/c should not be considered.

The liabilities payable to the third parties and to the preference shareholders is to be deducted from the total asset to arrive at the net assets.

The funds relating to equity shareholders such as General Reserve, Profit and Loss Account, Balance of Debenture Redemption Fund, Dividend Equalisation Reserve, Contingency Reserve, etc. should not be deducted.

YIELD BASIS METHOD:

The valuation of shares under the Yield Method may be done under two categories:

(a) Return on capital employed method:

This method is applied for the purpose of valuation of the shares of majority shareholding. A big investor is more interested in what the company earns and not simply in what the company distributes. Even if the company does not distribute 100% of its earning among its shareholders, it, as a matter of fact, strengthens the financial position of the company.

The value of the share under this method is calculated by the formula:

$$\text{Return on Capital Employed} = \frac{\text{Return of Capital Employed}}{\text{Normal Rate of Return}} \times \text{Paid-up Value of Shares}$$

(b) **Valuation on the basis of dividend:**

This method is more suitable for valuation of small block of shares.

The method of calculation is:

$$\frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid-up Value of Shares}$$

Following steps may be followed for calculating the value of shares according to Yield Method:

1. Calculation of average expected future profits
2. Calculation of expected return by the following equation:

$$\text{Expected Return} = \frac{\text{Expected Profits}}{\text{Equity Capital}} \times 100$$

3. Calculation of Yield Value per share:

$$\text{Value per Share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid up value per share}$$

PROBLEMS:

1. The following particulars are available in respect of Good luck Limited:

   (a) Capital 450, 60% preference shares of Rs 100 each fully paid and 4,500 equity shares of ` 10 each fully paid.

   (b) External liabilities: ` 7,500.

   (c) Reserves and Surplus ` 35,000.

   (d) The average expected profit (after taxation) earned by the company Rs 8,500.

   (e) The normal profit earned on the market value of equity shares (full paid) of the same type of companies is 9%.

   (f) 10% of the profit after tax is transferred to reserves.

   Calculate the intrinsic value per equity share and value per equity share according to dividend yield basis.

   Assume that out of total assets, assets worth of ` 350 are fictitious.

Valuation of Shares

- Meaning of Shares:
- The capital of the company can be divided into different units with definite value called shares.
- Thus shares is the shared capital in the firm giving ownership rights to the shareholders.

TYPES OF SHARES

- There are two types of Shares:
- Preference Shares: A Preference shares has two features;
- 1) A right to receive dividend at a given rate or amount before any dividend is paid.
- 2) A right to receive repayment of capital in the event of winding up of Company.

EQUITY SHARES

- An Equity Shares has the following features:
- 1) It gets dividend and repayment after payment to preference shareholders.
- 2) Rate of dividend is not fixed and is determined by directors.
- 3) such shareholders may go without any dividend if no profit is made.
- 4) They also have voting rights proportionate to one's share in the paid up capital.

Par Value of Shares

- An amount is noted on each share of a company. This is known as par value of the share. It is also known as the Face value of the share.

Market Value of Share

- It is the value at which the share is sold or purchased in the market. Market value may be more or less than the face value of the share.

Valuation of shares

- The shares which are included in the list of stock exchange are quoted but the shares which are not quoted are valued by various methods.

Need for Valuation

- When two or more companies amalgamate.
- When absorption of a company takes place.
- When loan is granted on the security of shares.
- When preference shares or debentures are converted into equity shares.
- When some shareholders do not give their consent for reconstruction of the Co., and these shares are valued for the purpose of acquisition

- When equity shareholders are to be compensated on acquisition of their shares by the govt. under a scheme of nationalization.
- When shares are held by the partners jointly in a company and dissolution takes place, it becomes necessary to value the shares for proper distribution of partnership property among the partners.

- When a portion of of shares is to be given by a member, fair price of these shares has to be made by an auditor or an accountant.

Factors affecting valuation of shares

- Nature of the business
- Demand and supply for shares
- Govt. policy
- Past performance of the company
- Growth prospectus of the company
- The management of the company
- The economic climate
- Accumulated reserves
- Prospects of bonus or rights issue
- Dividend declared etc.

<u>Methods for valuation</u>

- Net assets basis method: is also called intrinsic value or Networth valued Method or Assets Back Up Method.
- Yield basis method: Earning Capitalization Method or Earning Capacity Method and Dividend Yield Method or Expected Dividend Based Valuation
- Dual (or fair value) method

Net assets basis method

1. Net tangible assets basis

Under this method, net tangible assets are estimated in order to value the shares.

Net Assets = Assets – Liabilities

Assets are taken at their actual values (market values) and not at book values. In this method, goodwill is included with other tangible assets for the valuation of shares. Goodwill is taken at its actual value which maybe equal to, more than or less than the book value. Fictitious assets like preliminary expenses are excluded. All the liabilities (whether in books or not) are deducted. Non trading assets (Investments)are also included in the assets. Amount payable to preference shareholders is also deducted.

- value of share = net assets/no. of equity shares

Yield method

Use for valuation of small number of shares

Optimistic and Positive approach

Suitability of Yield Method:

Investor: More interested in Yield i.e Dividends or Earnings

Data Available – Earnings/ Dividend data readily available.

Steps to solve under Yield basis

Following steps are taken for calculating the value of shares under this method:

1. Calculation of average expected future profits (profit available for equity shareholders).
2. Calculation of expected return.

   Expected return= expected profits/equity share capital *100
3. Value of share= Expected rate/normal rate *paid up value of one share.

Average Expected future Profits

Average Profits

+/-

Future adjustments

-

Transfer to Reserve

-

Dividends to Pref Shareholders

= Profits available to equity Shareholders.

Valuation based on Rate of Dividend

- Value per share = Possible Rate of dividend/ Normal Rate of Dividend x Paid up value per share.
- Possible Rate of dividend = Total Profit available for dividend / Total paid up capital x 100

Dual or fair value method

It is simply a combination of the previous two methods. According to this method,

Value of share= net asset method value + yield method value/2

For eg:

Net asset method value: Rs. 10

Yield method value: Rs. 12

Fair value: Rs.10+Rs. 12/2 =Rs. 11

UNIT II

FORENSIC ACCOUNTING

MEANING

Forensic accounting utilizes accounting, auditing and investigative skills to conduct an examination into a company's financial statements. Forensic accounting provides an accounting analysis suitable for court. Forensic accountants are trained to look beyond the numbers and deal with the business reality of a situation. They are frequently used in fraud cases.

Forensic accounting is a specific area of accounting which investigates fraud and analyze financial information which can be utilized in legal trials. Forensic accounting is judicious mix of accounting, auditing and investigative skills to perform investigations of financial frauds. It is helpful for legal action and analytical Accounting.

Definition of Forensic Accounting:

According to the Journal of Forensic Accounting, "Forensic accounting is sufficiently thorough and complete so that an accountant, in his/ her considered independent professional judgment, can deliver a finding as to accounts, inventories, or the presentation thereof that is of such quality that it would be sustainable in some adversarial legal proceeding, or within some judicial or administrative review." (Fraud,the unmanaged Risk, 2003)

INDICATORS OF FRAUD

The following lists contain some of the possible indicators of fraud as well as work practices and employee behaviors which create an environment where fraud or corruption is more likely to occur. Any one of these indicators should act as a warning sign of a heightened risk of fraud, and the more indicators present, the higher is the risk of fraud taking place. The presence of one or more of the following indicators of fraud or corruption cannot be taken as evidence that such behavior is occurring. Such lapses in control may be the result of other factors. As a consequence, they should serve to raise awareness of risk and perhaps trigger closer monitoring or an informal review of systems or process. The scope of this policy must also be given appropriate consideration when analyzing these factors to determine potentially fraudulent or corrupt conduct.

• Missing expenditure vouchers & unavailable official records Crisis management coupled with a pressured business environment

- Excessive variations to budgets or contracts
- Bank reconciliations are not maintained or cannot be balanced
- Excessive movements of cash funds
- Unauthorized changes to systems or work practices
- Lowest tenders or quotes passed over with minimal explanation recorded
- Lost assets
- Absence of controls and audit trails
- Lack of clear financial delegation

• Employee Behavior Refusal, evasion or excessive delays in producing files, minutes or other

• records; Unexplained employee absences

- Gambling while at work
- Borrowing money from fellow employees while at work
- Placing undated or post-dated cheques in petty cash
- Personal creditors appearing at the workplace
- Covering up inefficiencies
- Excessive staff turnover in any specific position

• Employees with outside business interests or other jobs that conflict with their duties, other than those approved in connection with the University Consultancy Policy Signs of excessive drinking or drug abuse

- Managers bypassing subordinates, subordinates bypassing managers
- Secretiveness
- Marked character changes
- Excessive or apparent total lack of ambition
- Excessive control of records by one officer
- Refusal to comply with normal rules and practices

NEED FOR FORENSIC ACCOUNTING:

People and corporate are increasingly going for court action to resolve their problems,
• Trade transactions are increasing and getting more complex,
• People and corporate are having more problems with government,
• Employees involving with fraud is increasing and it is getting harder to unveil and prevent them,
• There have been increasing fraud with financial tables of companies and this led to increasing harm to society,
• It has come out that there has been increasing number and amounts of unsuccessful companies,
• Lawyers and courts need more support from specialists in the different areas of fraud,
• There has been increasing fraud in the virtual environment and the necessity of experts to fight against these,

The parties who will need Forensic Accounting Services;

• People and companies in business life,
• Banks,
• Attorneys at Law,
• Security forces,
• Insurance companies,
• Government offices,
• Courts

INDICATORS OF FRAUD:

Misrepresentation of facts with intention to mislead someone to believe these facts as true;

Parting with some valuable thing or money belonging to someone after getting induced by relying upon such facts,

Misappropriation of valuable thing or money belonging to someone who parted with it after getting induced by misrepresented facts causing or likely to cause loss of money and/or valuable things to the affected person.

Meaning of Forensic Audit:

Investopedia defines - A forensic audit is an examination and evaluation of a firm's or individual's financial information for use as evidence in court. A forensic audit can be conducted in order to prosecute a party for fraud, embezzlement or other financial claims.

Objectives of Forensic Auditing:

Following are objectives of Forensic Auditing

- To use the forensic accountant's conclusions to facilitate a settlement, claim, or jury award by reducing the financial component as an area of continuing debate
- To avoid fraud and theft
- To restore the downgraded public confidence
- To formulate and establish a comprehensive corporate governance policy
- To create a positive work environment

Techniques and tools of forensic audit

Different tool and techniques used for Forensic Audit are:

1. Benchmarking – comparison of financial result of one period with another or the performance of one cost centre, or business unit, with another and overall business performance with its pre decided standards.
2. Ratio analysis – to identify any abnormal trends and changes.
3. System analysis – to examine the systems in place and identifying any weaknesses which could be opportunities for the fraudsters.

4. Specialist software- like audit tools for data matching analysis.

5. Exception reporting –Generating automatic unchangeable reports that to find out deviation from the norms.

Problems of Forensic Accounting in India

1) Forensic accounting is developing field of financial fraud detection. There is acute shortage of qualified accountants with adequate technical knowledge of forensicissues in India.
2) In India, most of the financial fraud cases involved politicians, so it is crucial to find evidences against them.
3) Indian judicial system still follows age old British judicial system. It is expensive to bring the matter to court and hire expert advocates.
4) Due to liberalization and fast moving economy, more and more investors from foreign countries invest in India and so, it is difficult to sue financialfraudster from other countries.
5) Because of continuous adoption of new techniques of Information and Technology by fraudster, it is difficult to Forensic Accountant to cope up with them.
6) Forensic accounting is an expensive field compared to other investigativefields.
7) It is not mandatory for companies to appoint forensic accountant in companies.
8) There is no specific guideline or act on forensic accounting in India.

ETHICHS IN ACCOUNTING:

Accounting ethics is an important topic because, as accountants, we are the key personnel who access the financial information of individuals and entities. Such power also involves the potential and possibilities for abuse of information, or manipulation of numbers to enhance company perceptions or enforce earnings management. Ethics is also absolutely required in the course of an audit. Without meeting the requirements of auditing and accounting ethics, an audit must instantly be paused.

Ethics and the Code of the Conduct

Ethics and ethical behavior refer more to general principles such as honesty, integrity, and morals. The code of professional conduct, however, is a specific set of rules set by the governing bodies of chartered accountants. Although the rules set out by different bodies around the world are each unique, some rules are universal. Let's take a closer look at some of these important rules.

What is Ethics?

- Ethics may be defined as the set of moral principles that distinguish what is right from what is wrong.
- Ethics or moral philosophy is a branch of philosophy that involves systematizing, defending, and recommending concepts of right and wrong conduct.
- Ethics has a twofold objective: it evaluates human practices by calling upon moral standards.
- It may give prescriptive advice on how to act morally in a given situation.

What is Business Ethics?

- Business ethics focuses on what constitutes right or wrong behavior in the world of business.
- Corporate business executives have a responsibility to their shareholders and employees to make decisions that will help their business make a profit. But in doing so, businesspeople also have a responsibility to the public and themselves to maintain ethical principles.
- Although ethics provides moral guidelines, individuals must apply these guidelines in making decisions.

Why is Ethics important in Business?

The application of business ethics is important to an organisation for several reasons:

- Organisations' power and influence on society create potential for significant economic damage/benefit to individuals and communities.

- Stakeholder demands for greater accountability and ethical practice.
- Few managers have previously received formal business ethics training and thus need to acquire the skills to recognise ethical dilemmas and how to correctly manage the associated risks.
- The importance of business ethics reaches far beyond employee loyalty and morale or the strength of a management team bond.
- As with all business initiatives, the ethical operation of a company is directly related to profitability in both the short and long term.
- The reputation of a business from the surrounding community, other businesses and individual investors is paramount in determining whether a company is a worthwhile investment.
- If a company's reputation is less than perfect based on the perception that it does not operate ethically, investors are less inclined to buy stock or otherwise support its operations.
- With consistent ethical behavior comes increasingly positive public image, and there are few other considerations as important to potential investors and current shareholders.
- To retain a positive image, businesses must be committed to operating on an ethical foundation as it relates to treatment of employees, respect to the surrounding environment and fair market practices in terms of price and consumer treatment.

Importance of Ethics in Accounting

- Since the accounting profession involves various functions of accounting, such as, recording of all business events that are of financial character, classifying and summarizing them and present them in the form of profit and loss statement, balance sheet and cash flow statement, the way these activities are performed is very important and it has a lot do with maintaining accounting ethics of accountants.
- One of the most important things that shows ethical behavior of an accountant is that he needs to remain impartial and loyal to the business organization while performing the related activities sincerely and in all honesty.
- Since the accoun ting information drawn from the financial statements is of great value and significance to be relied upon and upon which the success or failure of a business

immensely depends, an accountant should not manipulate the accounting figures in order to hide any information.

- In terms of balance sheets, the information concerning, cash, receivables, inventory, prepaid expense, long term receivables etc must be presented accurately.

Ethical Principles for Business Executives

1. Honesty
2. Integrity
3. Promise keeping and Trustworthiness
4. Loyalty
5. Fairness
6. Concern for others
7. Respect for others
8. Law abiding
9. Commitment to excellence
10. Leadership
11. Reputation and morale
12. Accountability

HONESTY. Ethical executives are honest and truthful in all their dealings and they do not deliberately mislead or deceive others by misrepresentations, overstatements, partial truths, selective omissions, or any other means.

INTEGRITY. Ethical executives demonstrate personal integrity and the courage of their convictions by doing what they think is right even when there is great pressure to do otherwise; they are principled, honorable and upright; they will fight for their beliefs. They will not sacrifice principle for expediency, be hypocritical, or unscrupulous.

PROMISE-KEEPING & TRUSTWORTHINESS. Ethical executives are worthy of trust. They are candid and forthcoming in supplying relevant information and correcting misapprehensions of fact, and they make every reasonable effort to fulfill the letter and spirit of their promises and commitments. They do not interpret agreements in an unreasonably technical or legalistic manner in order to rationalize non-compliance or create justifications for escaping their commitments

LOYALTY. Ethical executives are worthy of trust, demonstrate fidelity and loyalty to persons and institutions by friendship in adversity, support and devotion to duty; they do not use or disclose information learned in confidence for personal advantage. They safeguard the ability to make independent professional judgments by scrupulously avoiding undue influences and conflicts of interest. They are loyal to their companies and colleagues and if they decide to accept other employment, they provide reasonable notice, respect the proprietary information of their former employer, and refuse to engage in any activities that take undue advantage of their previous positions.

FAIRNESS. Ethical executives and fair and just in all dealings; they do not exercise power arbitrarily, and do not use overreaching nor indecent means to gain or maintain any advantage nor take undue advantage of another's mistakes or difficulties. Fair persons manifest a commitment to justice, the equal treatment of individuals, tolerance for and acceptance of diversity, the they are open-minded; they are willing to admit they are wrong and, where appropriate, change their positions and beliefs.

CONCERN FOR OTHERS. Ethical executives are caring, compassionate, benevolent and kind; they like the Golden Rule, help those in need, and seek to accomplish their business objectives in a manner that causes the least harm and the greatest positive good.

RESPECT FOR OTHERS. Ethical executives demonstrate respect for the human dignity, autonomy, privacy, rights, and interests of all those who have a stake in their decisions; they are courteous and treat all people with equal respect and dignity regardless of sex, race or national origin.

LAW ABIDING. Ethical executives abide by laws, rules and regulations relating to their business activities.

COMMITMENT TO EXCELLENCE. Ethical executives pursue excellence in performing their duties, are well informed and prepared, and constantly endeavor to increase their proficiency in all areas of responsibility.

LEADERSHIP. Ethical executives are conscious of the responsibilities and opportunities of their position of leadership and seek to be positive ethical role models by their own conduct and by helping to create an environment in which principled reasoning and ethical decision making are highly prized.

REPUTATION AND MORALE. Ethical executives seek to protect and build the company's good reputation and the morale of its employees by engaging in no conduct that might undermine respect and by taking whatever actions are necessary to correct or prevent inappropriate conduct of others.

ACCOUNTABILITY. Ethical executives acknowledge and accept personal accountability for the ethical quality of their decisions and omissions to themselves, their colleagues, their companies, and their communities.

Organisational Ethical Values

- A key driver of organisational values will be the board demonstrating such values and embedding the values in the organisation's culture such that they become second nature to all employees.
- Any organisation which espouses such values to the market place will attract stakeholders who relate to those values (e.g. good university graduates will want to be employed by the organisation, customers will have faith in the goods and services provided by the organisation, suppliers and employees will provide high added-value inputs).
- Openness:

i. The ease with which employees and other stakeholders are able to make meaningful analysis of an organisation's culture, actions, economic and non-financial fundamentals.
ii. A measure of how good executive and other management is at making necessary regulatory and voluntary information, good and bad, available in a candid, accurate and timely manner to all relevant parties.
iii. Includes company management developing the appropriate culture at strategic and operational level.

Integrity and Trust:

i. Integrity requires that management and employees of an organisation should be open, straightforward and honest in all professional, business, personal and financial relationships. This implies honesty, fair dealing and truthfulness.
ii. Individual integrity describes a person of high moral value who observes a steadfast adherence to a strict moral code or ethical code notwithstanding pressures on them to act otherwise.
iii. As in many situations in life, trust is vital in corporate governance. Integrity provides the necessary ethical framework to engender trust.

Honesty:

i. Honesty and probity are fundamental to corporate governance. They cover integrity, honour, virtue and fair dealing.
ii. Honesty implies that the organisation, management or employees do not mislead anyone (e.g. shareholders, the market, management, employees) on any matter.
iii. At a higher level, the chief executive provides all appropriate information to fellow executive directors and NEDs.

Respect:

i. Respect is a 360-degree, three-dimensional ethical value based on principles of right and wrong. A person shows respect by caring about principles, people and property. To respect is to care, and to care shows respect.
ii. Respect is more than a feeling; it is an ethical obligation. For example, an extract from a code of ethics cautions employees: We treat employees, customers and all people with respect at all times.

Empowerment :

i. Empowerment is the process of enabling or authorising autonomous thinking, behaviour, action and control over work and decision-making.
ii. It aims to increase an employee's discretionary decisionmaking authority either by direct authority from management or through self-awareness and actions in the culture of an organisation.

Accountability:

i. In the context of management, accountability involves acknowledgment and assumption of responsibility for actions, products, decisions and policies encompassing the obligation to report, explain and answer for resulting consequences.
ii. In the context of ethical behaviour, accountability is an accepted norm. Being ethical implies that you would not abuse your power, you would accept responsibility for your actions and would be accountable to those stakeholders your actions affect.

Corporate Code of Ethics

- Under the Sarbanes-Oxley Act (2002), a code of ethics is defined as: "A codification of standards that is reasonably designed to deter wrongdoing and to promote:

(i) honest and ethical conduct, including the ethical handling of actual and apparent conflicts of interest;
(ii) full, fair, accurate, timely and understandable disclosure in reports and documents filed with or submitted to the SEC;
(iii) compliance with applicable laws, rules and regulations;
(iv) prompt internal reporting of code violations to an appropriate person; and
(v) accountability for adherence to the code."

Benefits of a Code:

i. To define accepted/acceptable behaviours.
ii. To promote high standards of practice.
iii. To provide a benchmark for members to use for self-evaluation.
iv. To establish a framework for professional behaviour and responsibilities.
v. As a vehicle for occupational identity.
vi. As a mark of occupational maturity.

There are two main types of a code of ethics:

1. Stakeholder-based—i.e. setting out organisational commitments and staff guidance based on relationships with different stakeholders; and
2. Issues-based—offering guidance formulated on issues of concern to the firm.

Stakeholder based content:

- How to use the code—its purpose, relevance, audience and context. Describe tools or sources of support and summarise the ethical decision-making framework.
- Employees—policies on working conditions, recruitment, development and training, rewards, health and safety, equal opportunities, diversity, retirement, redundancy, discrimination and harassment and use of company assets by employees.
- Customer relations—the importance of customer satisfaction and fair dealing in all agreements, quality, pricing and aftersales service.
- Shareholders and lenders—how their investment is protected and proper return made. A commitment to accurate and timely communication on achievements and prospects.
- Suppliers—prompt settlement of amounts due. Cooperation to achieve quality and efficiency. No bribery or excess hospitality accepted or given.
- Society or the wider community—compliance with the "spirit" of laws, not just "the letter". Obligations to protect and preserve the environment. Staff involvement in local affairs. Policy on sponsorship, education and charitable giving.
- Implementation and reinforcement—how issued and used and how to get advice. How and to whom to report breaches of the code. Awareness raising illustrations and training programmes.
- Assurance, reporting and reviews—measuring effectiveness, annual reporting to the board and updating procedures.

Issues-based Content:

- The oldest recorded use of the word profession, "avowal or expression of purpose," implied religious and moral motives to dedicate oneself to good end.
- By the 16th century, "profession" had been extended from its original religious connection and was used for all three of the university-educated occupations—divinity, law and medicine— all of which held high status.
- All three professions were concerned with the well-being of individuals obliged to put their trust in members of these occupations if they wished to consult with them. The requirement of trust led to the development of ethical standards and a commitment to provide a service for the public good.

Characteristics:

- There have been many attempts to define a profession through its characteristics:

i. Expertise—including specialised knowledge and skill.
ii. Responsibility—to perform a service that is essential to society.

Corporateness—a collective sense of unity which originates from the lengthy discipline and training necessary for professional competence, the common bond of work and the sharing of a social responsibility. This sets the professional member apart from laymen.

Another model specifies six characteristics:

1. An intellectual technique.
2. An application of that technique.
3. A long period of training.

4. An association of members.
5. Enforced standards and a statement of ethics.
6. A body of intellectual theory.

According to IESBA's Code of Ethics for Professional Accountants, the objectives of the accountancy profession are:

i. to work to the highest standards of professionalism;
ii. to attain the highest levels of performance; and
iii. generally to meet the public interest requirement.
iv. These objectives satisfy four basic needs:

1. Credibility—society needs credibility in information and information systems.
2. Professionalism—individuals need to be clearly identifiable by clients, employers and other interested parties as professional persons in the accountancy field. 3. Quality of services—there is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.
4. Confidence—users of the services of professional accountants should be able to see, as well as feel confident, that they are governed by a framework of professional ethics.

Public Interest

- ❖ It may be defined as "The collective well-being of the community of people and institutions the professional accountant serves.“
- ❖ There is no one objective or legal definition of public interest. It is subjective and can mean different things to different groups of people.

It often has been used as an excuse to cross the boundary between private matters and public interest.

The Professional Accountant

- ❖ Clearly a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer.
- ❖ The standards of the professional accountant are heavily determined by the public interest, for example:

i. independent auditors help to maintain the integrity of financial statements presented to financial institutions in support of loans and to stockholders for raising capital;
ii. financial executives serve in various financial management capacities in organisations and contribute to efficient and effective use of resources;

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Conflicts and Dilemmas

- Conflicts of interest: "a situation that has the potential to undermine a person's impartiality or objectivity and, thus, integrity because of possible divergence between that person's self-interest and a professional or public interest."
- Where ethical conflicts and dilemmas arise, they primarily are in the guise of conflicts of interest.
- Conflicts of interest may be:

i. Personal v employer—being required to act in an unprofessional way because of a threat to promotion or loss of employment; acting in a particular way to protect the interests of a family member or friend; or disagreement over a particular ethical stance taken by the employer.
ii. Client v member—giving a client bad advice in order to earn more fees or referring a client to a particular agent, regardless of the client's needs, because that agent provides a greater commission or other benefit to the member.

Client v client—acting for two clients who are major competitors

Key requirements to avoid conflicts of interest include:

- Members should place clients' and public interests before their own.
- A firm should not accept or continue an engagement in which there is or is likely to be a significant conflict of interest between the firm and the client.
- Any financial gain which accrues or is likely to accrue to the firm as a result of the engagement (other than properly earned fees, etc) will always amount to a significant conflict of interest.
- The firm's work should be managed to avoid the interests of one client adversely affecting those of another.

Ethical Threats

- An ethical threat arises when an individual, or an organisation, is presented with an option that requires them to violate their ethical code or standards.
- Their action would be a breach of the ethical culture of the organisation.
- Causes:

i. Cultural differences resulting in different expectations and practices.
ii. Opportunities where ethical problems are not reported or discovered.
iii. Lack of opportunities for rectification due to lack of resources.
iv. Failure to recognise the ethical dimensions of situations, lack of ethical sensitivity.
v. Lack of understanding of the issues and consequences.

- Possible safeguards include:

i. general control mechanisms in risk functions, such as codes of conduct, rules and regulations;
ii. peer review, external reviews and self-review processes;

iii. disciplinary procedures including guidelines and hearing procedures;
iv. ethics awareness, education and development initiatives;
v. promotion of an understanding between ethics and standards among employees.

Problems and Challenges

- Organisations operate in an open, dynamic and ever-changing global environment.
- There are many ethical pitfalls and traps awaiting the unwary.
- The following are just a small sample of the types of ethical challenges which face organisations, their managers and employees.

Generally Accepted Practice:

- Some organisations have "generally accepted practices" which amount to theft or misuse of company assets but are tolerated by management as part of "tradition", "culture" or "something to keep the employees happy".
- Examples include:

i. use of business phones/computers for private activity;
ii. claiming for expenses not incurred (e.g. taking a friend to lunch and then claiming it as "potential client entertainment");
iii. holding lavish private parties and inviting a few business friends, then putting the entire expense through company accounts as business entertainment;
iv. inflating mileage claims.

Setting Precedent

- Ethical principles and organisational codes of ethics must be applied to all regardless of their position in the organisation. If the belief in "one rule for them and a totally different one for us" takes hold in an organisation, the moral and ethical structure of that organisation will collapse.
- Once a precedent has been set in applying a code of ethics (e.g. an employee was sacked for unethical use of company assets) then the same principles must be applied should a senior manager breach the same rules.

Gifts and Hospitality:

- As discussed, giving and receiving gifts can create many ethical issues. In some cases, doing so would be considered accepting/giving a bribe while in other cases, not to do so may be considered an insult.
- In addition, it is not uncommon for some organisations to be asked by other organisations or individuals for "consultancy or arrangement fees" to ensure that "the process flows smoothly" (often referred to as "grease money").

Conflicts of Interest

- Conflicts of interest arise when an individual or organisation has competing professional or personal interests that make impartial and independent judgement difficult.
- The individual or corporation is in a position to exploit a professional or official capacity in some way for personal or corporate benefit rather than follow a fiduciary or legal duty (e.g. to maximise the wealth of shareholders and not to make a secret individual profit).

- A conflict of interest can exist even if no unethical or improper act results, as it will still create an appearance of impropriety which can undermine confidence in the person or organisation.

Insider Dealing:
The process where individuals use, or encourage others to use, information regarding a company, which is not generally available, to deal for their own financial advantage (other than in the proper performance of their own job)." —UK Financial Services Authority (FSA). In some cultures, insider dealing is not considered to be unethical. In others, it is specifically illegal.
Equal Opportunities and Discrimination: International companies have to pay particular attention to different cultural approaches to equal opportunities and discrimination (e.g. in some countries women are not allowed to mix with men in the workplace).

ETHICS
AND
ETHICAL BEHAVIOUR

WHAT IS ETHICS?

- Ethics may be defined as the set of moral principles that distinguish what is right from what is wrong.
- **Ethics** or **moral philosophy** is a branch of philosophy that involves systematizing, defending, and recommending concepts of right and wrong conduct.
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WHAT IS BUSINESS ETHICS?

- Business ethics focuses on what constitutes right or wrong behavior in the world of business.
- Corporate business executives have a responsibility to their shareholders and employees to make decisions that will help their business make a profit. But in doing so, businesspeople also have a responsibility to the public and themselves to maintain ethical principles.
- Although ethics provides moral guidelines, individuals must apply these guidelines in making decisions.

WHY IS ETHICS IMPORTANT IN BUSINESS?

The application of business ethics is important to an organisation for several reasons:

- ❖ Organisations' power and influence on society create potential for significant economic damage/benefit to individuals and communities.
- ❖ Stakeholder demands for greater accountability and ethical practice.
- ❖ Few managers have previously received formal business ethics training and thus need to acquire the skills to recognise ethical dilemmas and how to correctly manage the associated risks.

- The importance of business ethics reaches far beyond employee loyalty and morale or the strength of a management team bond.
- As with all business initiatives, the ethical operation of a company is directly related to profitability in both the short and long term.
- The reputation of a business from the surrounding community, other businesses and individual investors is paramount in determining whether a company is a worthwhile investment.
- If a company's reputation is less than perfect based on the perception that it does not operate ethically, investors are less inclined to buy stock or otherwise support its operations.

- With consistent ethical behavior comes increasingly positive public image, and there are few other considerations as important to potential investors and current shareholders.
- To retain a positive image, businesses must be committed to operating on an ethical foundation as it relates to treatment of employees, respect to the surrounding environment and fair market practices in terms of price and consumer treatment.

IMPORTANCE OF ETHICS IN ACCOUNTING

❖ Since the accounting profession involves various functions of accounting, such as, recording of all business events that are of financial character, classifying and summarizing them and present them in the form of profit and loss statement, balance sheet and cash flow statement, the way these activities are performed is very important and it has a lot do with maintaining accounting ethics of accountants.

- One of the most important things that shows ethical behavior of an accountant is that he needs to remain impartial and loyal to the business organization while performing the related activities sincerely and in all honesty.
- Since the accoun ting information drawn from the financial statements is of great value and significance to be relied upon and upon which the success or failure of a business immensely depends, an accountant should not manipulate the accounting figures in order to hide any information.
- In terms of balance sheets, the information concerning, cash, receivables, inventory, prepaid expense, long term receivables etc must be presented accurately.

12 ETHICAL PRINCIPLES FOR BUSINESS EXECUTIVES

1. Honesty
2. Integrity
3. Promise keeping and Trustworthiness
4. Loyalty
5. Fairness
6. Concern for others

7. Respect for others
8. Law abiding
9. Commitment to excellence
10. Leadership
11. Reputation and morale
12. Accountability

1. **HONESTY.** Ethical executives are honest and truthful in all their dealings and they do not deliberately mislead or deceive others by misrepresentations, overstatements, partial truths, selective omissions, or any other means.
2. **INTEGRITY.** Ethical executives demonstrate personal integrity and the courage of their convictions by doing what they think is right even when there is great pressure to do otherwise; they are principled, honorable and upright; they will fight for their beliefs. They will not sacrifice principle for expediency, be hypocritical, or unscrupulous.
3. **PROMISE-KEEPING & TRUSTWORTHINESS.** Ethical executives are worthy of trust. They are candid and forthcoming in supplying relevant information and correcting misapprehensions of fact, and they make every reasonable effort to fulfill the letter and spirit of their promises and commitments. They do not interpret agreements in an unreasonably technical or legalistic manner in order to rationalize non-compliance or create justifications for escaping their commitments

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4. LOYALTY. Ethical executives are worthy of trust, demonstrate fidelity and loyalty to persons and institutions by friendship in adversity, support and devotion to duty; they do not use or disclose information learned in confidence for personal advantage. They safeguard the ability to make independent professional judgments by scrupulously avoiding undue influences and conflicts of interest. They are loyal to their companies and colleagues and if they decide to accept other employment, they provide reasonable notice, respect the proprietary information of their former employer, and refuse to engage in any activities that take undue advantage of their previous positions.

5. FAIRNESS. Ethical executives and fair and just in all dealings; they do not exercise power arbitrarily, and do not use overreaching nor indecent means to gain or maintain any advantage nor take undue advantage of another's mistakes or difficulties. Fair persons manifest a commitment to justice, the equal treatment of individuals, tolerance for and acceptance of diversity, the they are open-minded; they are willing to admit they are wrong and, where appropriate, change their positions and beliefs.

6. CONCERN FOR OTHERS. Ethical executives are caring, compassionate, benevolent and kind; they like the Golden Rule, help those in need, and seek to accomplish their business objectives in a manner that causes the least harm and the greatest positive good.

7. RESPECT FOR OTHERS. Ethical executives demonstrate respect for the human dignity, autonomy, privacy, rights, and interests of all those who have a stake in their decisions; they are courteous and treat all people with equal respect and dignity regardless of sex, race or national origin.

8. LAW ABIDING. Ethical executives abide by laws, rules and regulations relating to their business activities.

9. COMMITMENT TO EXCELLENCE. Ethical executives pursue excellence in performing their duties, are well informed and prepared, and constantly endeavor to increase their proficiency in all areas of responsibility.

10. LEADERSHIP. Ethical executives are conscious of the responsibilities and opportunities of their position of leadership and seek to be positive ethical role models by their own conduct and by helping to create an environment in which principled reasoning and ethical decision making are highly prized.

11. REPUTATION AND MORALE. Ethical executives seek to protect and build the company's good reputation and the morale of its employees by engaging in no conduct that might undermine respect and by taking whatever actions are necessary to correct or prevent inappropriate conduct of others.

12. ACCOUNTABILITY. Ethical executives acknowledge and accept personal accountability for the ethical quality of their decisions and omissions to themselves, their colleagues, their companies, and their communities.

ORGANISATIONAL ETHICAL VALUES

❖ A key driver of organisational values will be the board demonstrating such values and embedding the values in the organisation's culture such that they become second nature to all employees.

❖ Any organisation which espouses such values to the market place will attract stakeholders who relate to those values (e.g. good university graduates will want to be employed by the organisation, customers will have faith in the goods and services provided by the organisation, suppliers and employees will provide high added-value inputs).

❖ **Openness:**

i. The ease with which employees and other stakeholders are able to make meaningful analysis of an organisation's culture, actions, economic and non-financial fundamentals.

ii. A measure of how good executive and other management is at making necessary regulatory and voluntary information, good and bad, available in a candid, accurate and timely manner to all relevant parties.

iii. Includes company management developing the appropriate culture at strategic and operational level.

❖ **Integrity and Trust:**

i. Integrity requires that management and employees of an organisation should be open, straightforward and honest in all professional, business, personal and financial relationships. This implies honesty, fair dealing and truthfulness.

ii. Individual integrity describes a person of high moral value who observes a steadfast adherence to a strict moral code or ethical code notwithstanding pressures on them to act otherwise.

iii. As in many situations in life, trust is vital in corporate governance. Integrity provides the necessary ethical framework to engender trust.

❖ **Honesty:**

i. Honesty and probity are fundamental to corporate governance. They cover integrity, honour, virtue and fair dealing.

ii. Honesty implies that the organisation, management or employees do not mislead anyone (e.g. shareholders, the market, management, employees) on any matter.

iii. At a higher level, the chief executive provides all appropriate information to fellow executive directors and NEDs.

- **Respect:**

i. Respect is a 360-degree, three-dimensional ethical value based on principles of right and wrong. A person shows respect by caring about principles, people and property. To respect is to care, and to care shows respect.

ii. Respect is more than a feeling; it is an ethical obligation. For example, an extract from a code of ethics cautions employees: We treat employees, customers and all people with respect at all times.

- **Empowerment :**

i. Empowerment is the process of enabling or authorising autonomous thinking, behaviour, action and control over work and decision-making.

ii. It aims to increase an employee's discretionary decisionmaking authority either by direct authority from management or through self-awareness and actions in the culture of an organisation.

- **Accountability:**

i. In the context of management, accountability involves acknowledgment and assumption of responsibility for actions, products, decisions and policies encompassing the obligation to report, explain and answer for resulting consequences.

ii. In the context of ethical behaviour, accountability is an accepted norm. Being ethical implies that you would not abuse your power, you would accept responsibility for your actions and would be accountable to those stakeholders your actions affect.

CORPORATE CODE OF ETHICS

❖ Under the Sarbanes-Oxley Act (2002), a code of ethics is defined as: "A codification of standards that is reasonably designed to deter wrongdoing and to promote:

(i) honest and ethical conduct, including the ethical handling of actual and apparent conflicts of interest;

(ii) full, fair, accurate, timely and understandable disclosure in reports and documents filed with or submitted to the SEC;

(iii) compliance with applicable laws, rules and regulations;

(iv) prompt internal reporting of code violations to an appropriate person; and

(v) accountability for adherence to the code."

❖ **Benefits of a Code:**

i. To define accepted/acceptable behaviours.

ii. To promote high standards of practice.

iii. To provide a benchmark for members to use for self-evaluation.

iv. To establish a framework for professional behaviour and responsibilities.

v. As a vehicle for occupational identity.

vi. As a mark of occupational maturity.

❖ There are two main types of a code of ethics:

1. **Stakeholder-based**—i.e. setting out organisational commitments and staff guidance based on relationships with different stakeholders; and

2. **Issues-based**—offering guidance formulated on issues of concern to the firm.

STAKEHOLDER BASED CONTENT:

- **How to use the code**—its purpose, relevance, audience and context. Describe tools or sources of support and summarise the ethical decision-making framework.
- **Employees**—policies on working conditions, recruitment, development and training, rewards, health and safety, equal opportunities, diversity, retirement, redundancy, discrimination and harassment and use of company assets by employees.
- **Customer relations**—the importance of customer satisfaction and fair dealing in all agreements, quality, pricing and aftersales service.
- **Shareholders and lenders**—how their investment is protected and proper return made. A commitment to accurate and timely communication on achievements and prospects.

- **Suppliers**—prompt settlement of amounts due. Cooperation to achieve quality and efficiency. No bribery or excess hospitality accepted or given.
- **Society or the wider community**—compliance with the "spirit" of laws, not just "the letter". Obligations to protect and preserve the environment. Staff involvement in local affairs. Policy on sponsorship, education and charitable giving.
- **Implementation and reinforcement**—how issued and used and how to get advice. How and to whom to report breaches of the code. Awareness raising illustrations and training programmes.
- **Assurance, reporting and reviews**—measuring effectiveness, annual reporting to the board and updating procedures.

ISSUES-BASED CONTENT:

- Competition
- Bribery and corruption
- Gifts and entertainment
- Conflicts of interest
- Use of company assets
- Information security
- Political contributions
- Human rights standards
- Environmental responsibilities
- Health and safety
- Discrimination
- Work/home balance issues
- Other issues.

PROFESSIONAL ETHICS

- The oldest recorded use of the word profession, "avowal or expression of purpose," implied religious and moral motives to dedicate oneself to good end.
- By the 16th century, "profession" had been extended from its original religious connection and was used for all three of the university-educated occupations—divinity, law and medicine— all of which held high status.
- All three professions were concerned with the well-being of individuals obliged to put their trust in members of these occupations if they wished to consult with them. The requirement of trust led to the development of ethical standards and a commitment to provide a service for the public good.

CHARACTERISTICS:

❖ There have been many attempts to define a profession through its characteristics:

i. **Expertise**—including specialised knowledge and skill.

ii. **Responsibility**—to perform a service that is essential to society.

iii. **Corporateness**—a collective sense of unity which originates from the lengthy discipline and training necessary for professional competence, the common bond of work and the sharing of a social responsibility. This sets the professional member apart from laymen.

❖ Another model specifies six characteristics:

1. An intellectual technique.
2. An application of that technique.
3. A long period of training.
4. An association of members.
5. Enforced standards and a statement of ethics.
6. A body of intellectual theory.

❖ According to IESBA's Code of Ethics for Professional Accountants, the objectives of the accountancy profession are:

i. to work to the highest standards of professionalism;
ii. to attain the highest levels of performance; and
iii. generally to meet the public interest requirement.

❖ These objectives satisfy four basic needs:

1. **Credibility**—society needs credibility in information and information systems.

2. **Professionalism**—individuals need to be clearly identifiable by clients, employers and other interested parties as professional persons in the accountancy field. 3. **Quality of services**—there is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.

4. **Confidence**—users of the services of professional accountants should be able to see, as well as feel confident, that they are governed by a framework of professional ethics.

PUBLIC INTEREST

- It may be defined as "The collective well-being of the community of people and institutions the professional accountant serves.“
- There is no one objective or legal definition of public interest. It is subjective and can mean different things to different groups of people.
- It often has been used as an excuse to cross the boundary between private matters and public interest.

THE PROFESSIONAL ACCOUNTANT

- Clearly a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer.
- The standards of the professional accountant are heavily determined by the public interest, for example:

i. independent auditors help to maintain the integrity of financial statements presented to financial institutions in support of loans and to stockholders for raising capital;

ii. financial executives serve in various financial management capacities in organisations and contribute to efficient and effective use of resources;

CONFLICTS AND DILEMMAS

- **Conflicts of interest**: "a situation that has the potential to undermine a person's impartiality or objectivity and, thus, integrity because of possible divergence between that person's self-interest and a professional or public interest."

- Where ethical conflicts and dilemmas arise, they primarily are in the guise of conflicts of interest.

- Conflicts of interest may be:

i. **Personal v employer**—being required to act in an unprofessional way because of a threat to promotion or loss of employment; acting in a particular way to protect the interests of a family member or friend; or disagreement over a particular ethical stance taken by the employer.

ii. **Client v member**—giving a client bad advice in order to earn more fees or referring a client to a particular agent, regardless of the client's needs, because that agent provides a greater commission or other benefit to the member.

iii. **Client v client**—acting for two clients who are major competitors

Key requirements to avoid conflicts of interest include:

- Members should place clients' and public interests before their own.
- A firm should not accept or continue an engagement in which there is or is likely to be a significant conflict of interest between the firm and the client.
- Any financial gain which accrues or is likely to accrue to the firm as a result of the engagement (other than properly earned fees, etc) will always amount to a significant conflict of interest.
- The firm's work should be managed to avoid the interests of one client adversely affecting those of another.

ETHICAL THREATS

- An ethical threat arises when an individual, or an organisation, is presented with an option that requires them to violate their ethical code or standards.
- Their action would be a breach of the ethical culture of the organisation.
- **Causes:**

i. Cultural differences resulting in different expectations and practices.

ii. Opportunities where ethical problems are not reported or discovered.

iii. Lack of opportunities for rectification due to lack of resources.

iv. Failure to recognise the ethical dimensions of situations, lack of ethical sensitivity.

v. Lack of understanding of the issues and consequences.

❖ Possible safeguards include:

i. general control mechanisms in risk functions, such as codes of conduct, rules and regulations;

ii. peer review, external reviews and self-review processes;

iii. disciplinary procedures including guidelines and hearing procedures;

iv. ethics awareness, education and development initiatives;

v. promotion of an understanding between ethics and standards among employees.

PROBLEMS AND CHALLENGES

- ❖ Organisations operate in an open, dynamic and ever-changing global environment.
- ❖ There are many ethical pitfalls and traps awaiting the unwary.
- ❖ The following are just a small sample of the types of ethical challenges which face organisations, their managers and employees.

GENERALLY ACCEPTED PRACTICE:

❖ Some organisations have "generally accepted practices" which amount to theft or misuse of company assets but are tolerated by management as part of "tradition", "culture" or "something to keep the employees happy".

❖ Examples include:

i. use of business phones/computers for private activity;

ii. claiming for expenses not incurred (e.g. taking a friend to lunch and then claiming it as "potential client entertainment");

iii. holding lavish private parties and inviting a few business friends, then putting the entire expense through company accounts as business entertainment;

iv. inflating mileage claims.

SETTING PRECEDENT:

- ❖ Ethical principles and organisational codes of ethics must be applied to all regardless of their position in the organisation. If the belief in "one rule for them and a totally different one for us" takes hold in an organisation, the moral and ethical structure of that organisation will collapse.
- ❖ Once a precedent has been set in applying a code of ethics (e.g. an employee was sacked for unethical use of company assets) then the same principles must be applied should a senior manager breach the same rules.

GIFTS AND HOSPITALITY:

❖ As discussed, giving and receiving gifts can create many ethical issues. In some cases, doing so would be considered accepting/giving a bribe while in other cases, not to do so may be considered an insult.

❖ In addition, it is not uncommon for some organisations to be asked by other organisations or individuals for "consultancy or arrangement fees" to ensure that "the process flows smoothly" (often referred to as "grease money").

CONFLICTS OF INTEREST

- Conflicts of interest arise when an individual or organisation has competing professional or personal interests that make impartial and independent judgement difficult.
- The individual or corporation is in a position to exploit a professional or official capacity in some way for personal or corporate benefit rather than follow a fiduciary or legal duty (e.g. to maximise the wealth of shareholders and not to make a secret individual profit).
- A conflict of interest can exist even if no unethical or improper act results, as it will still create an appearance of impropriety which can undermine confidence in the person or organisation.

INSIDER DEALING:

"The process where individuals use, or encourage others to use, information regarding a company, which is not generally available, to deal for their own financial advantage (other than in the proper performance of their own job)." —UK Financial Services Authority (FSA). In some cultures, insider dealing is not considered to be unethical. In others, it is specifically illegal.

Equal Opportunities and Discrimination: International companies have to pay particular attention to different cultural approaches to equal opportunities and discrimination (e.g. in some countries women are not allowed to mix with men in the workplace).

THE END