BUSINESS ETHICS AND CORPORATE GOVERNANCE

Executive Summary:

The current report is concerned with analyzing the case of Pringles Ltd. in respect of changing its depreciation method. Pringles Ltd. changed its depreciation method from straight line to sum of years' digit method to show consistent profit over the years. The report indicates that Pringles Ltd. changed its depreciation policy for a reason which is not in the best interest of the shareholders and thus unethical. Furthermore, non-disclosure of the change in depreciation method violates relevant accounting standards which further raises questions over the corporate governance system of Pringles Ltd. Thus, it is advisable for the company to disclose the changes in depreciating accounting and adhere to relevant accounting standards pertaining to the same.

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Analysis of the Case:

Depreciation refers to the allocation of the financial value of an asset over the useful life of the concerned asset. Depreciation is debited to the income statement. Here, it is important to understand that depreciation is not an expense instead it is an allocation of cost of an asset and that no cash outflow takes place through depreciation. In this context, El Kasmioui and Ceulemans (2013) mentioned that with the charging of depreciation, the value of assets get reduced as the amount of depreciation is deducted from the cost of assets in the balance sheet. The main purpose of depreciation is to stay prepared financially for the replacement of assets post expiry of useful life. Natural wear & tear and technological advancements are the two main reasons for the reduction of usability of an asset.

There are various methods of charging depreciation. Though, there is no mandatory instruction as per the International Financial Regulatory Standards (IFRS) or Generally Accepted Accounting

Principles (GAAP) but both of these lay stress on maintaining consistency in accounting and financial reporting. In the current scenario, Pringles Ltd. had been charging depreciation following the straight line method. Under the straight line method of depreciation, the estimated life of an asset is first determined. This is followed by dividing the cost of asset minus salvage value by the estimated useful life of the asset. The result so obtained is then multiplied by 100 to get the rate of depreciation. According to McNulty et al. (2013), the straight line method of depreciation involves deducting a fixed amount of depreciation from concerned assets every year. On the other hand, CEO of Pringles Ltd. had ordered the accountant to change the depreciation method from straight line method to sum of the years' digit method. Here, it is important to note that the sum of

years' digit technique of depreciation is mainly focused on accelerating the depreciation charging process. In other words, under this method, the majority of the depreciation amount is charged within the first few years of its useful life. It is alternatively known as the diminishing balance method or reducing balance method of depreciation. Furthermore, under the sum of years' digit method, depreciation is charged on the Written Down Value (WDV) of an asset every year. WDV is the financial value of an asset that is remaining after deducting depreciation from the original cost for any particular year.

Changing the method of depreciation have major impacts on the corporate governance and business ethics of Pringles Ltd. However, prior to understanding the ethical and corporate

governance aspects associated with this decision of the management it is important to have a clear idea about the advantages and disadvantages of the sum of years' digit method of depreciation. In this context, Ou et al. (2014) mentioned that the sum of years' digit method of depreciation helps in equalizing the yearly burden of repairs & depreciation on the profit and loss account of the company. Under these tactics, the amount of depreciation keeps on reducing with the increase in the number of years while the repairing costs get increased. On the contrary, Masulis et al. (2012) observed that the sum of years' digit depreciation technique results in a heavy depreciation amount in the initial years. As regards the straight line method of depreciation, it provides an equal amount of depreciation throughout the life of an asset.

In the present context, changing of the depreciation method and that too without informing the shareholders have major impacts on corporate governance and business ethics of Pringles Ltd. Here, it is important to note that business ethics is an integral aspect of corporate governance. Business ethics can be defined as a form of applied ethics that is concerned with the moral, professional ethics, ethical principles and ethical problems in respect of a business organization and within the entire business environment. In other words, business ethics determine the extent to which a company has been operating with a good moral. On the other hand, corporate governance refers to an organized system of rules, regulations, principles, values, processes and procedures that are used to direct and control a company. Balancing interests of different stakeholders like the employees, shareholders, customers, suppliers, society and the government is a key function of corporate governance (Doucette et al. 2012).

In the present context, the intention of the management of Pringles Ltd. behind changing the depreciation method is not honest. The primary objective of changing the depreciation method by Pringles Ltd. is to manipulate financial accounts and create a misleading impression on the shareholders. Here, it is important to note that changing depreciation methods or any other accounting policies is not an unethical one. For example, a company can change the depreciation method or inventory valuation method to adjust against inflation in the market. However, in the current scenario, the motive of Pringles Ltd. is to mislead the shareholders by showing a constant profitability over the years which is not the case in reality. Corporate governance of Pringles Ltd. is under question as the same is playing foul with the shareholders. In this context, Palea and Maino (2013) mentioned that appropriate communication is a key element of corporate governance and also determines the effectiveness of corporate governance of an organization. The communication process of Pringles Ltd. is getting negatively affected by changing the depreciation method.

Managing stakeholders' interest is a key function of corporate governance. Here, managing stakeholders' interest implies identifying the interest & powers of stakeholders and acting in a way to fulfill stakeholders' interest and balance varied interest among different stakeholders. However, misrepresenting financial statements to create a false impression among the stakeholders can never be an element of good corporate governance.

Here, it is important to note that Pringles Ltd. has made two major mistakes which negatively impact its corporate governance and are also against business ethics. Firstly, the company changed the depreciation method to show consistency in profit margin over multiple years. Secondly, the company concealed the information in its annual report as the accountant did not disclose the change in depreciation method in the notes to the financial statements. This is

making the shareholders and investors believe that the company is earning good profits following the previous straight line method of depreciation. As per the norms of IFRS, a company is required to mention change in accounting policies as notes to financial statements since changes in accounting policies have major impacts on the financial performance and financial position of the company

(Reddy et al. 2013). On the other hand, according to the convention of materiality in respect of financial accounting, a company is needed to account for and disclose all material information in

its financial reporting. Change in the depreciation method is a material element as it affects profits and thus needs to be disclosed in the financial statements.

The decision of changing the depreciation method and concealing the same have major impacts on the stakeholders of Pringles Ltd. Two of the main stakeholders of Pringles Ltd. are shareholders and creditors. Shareholders are the ones who provide the necessary capital to the company in the form of equity whereas creditors are the ones who provide funds in the form of debts to the company. Shareholders and creditors, both rely heavily on the financial statements of a company before deciding on investment or lending. Profit is the key motive of any business and thus profitability is considered as a key parameter to judge a company's financial performance and position by both shareholders & creditors (Zhuang and Luo, 2015). However, intentionally showing wrong distribution of profits over the years is somehow like influencing the perception of shareholders and creditors to obtain cooperation from the same.

The Australian Accounting Standards Board (AASB) 101 deals with the presentation of financial statements. This standard is applicable to the current scenario. AASB 101 is similar like that of International Accounting Standards (IAS) 1. The objective of AASB 101 is to lay down the basis in context of financial statements' preparation. The standard is applicable for financial reporting from 1st January 2009 but early adoption from 1st January 2005 is allowed. AASB 101 is concerned with financial statements, financial reporting, notes, schedules, material, profit or loss, comprehensive income, owners along with special purpose financial statements. Statement of financial position, income statement, cash flow statement, statement of changes in equity, statement of comprehensive income and notes come under the purview of AASB 101. According to the AASB 101, companies are required to fairly present the financial performance, financial position and cash flows of the business. Also, the Corporations Act, 2001 requires companies to be compliant to the Australian Accounting Standards (AAS). AASB 101 further requires organizations to disclose in the notes a statement stating whether the financial statements were prepared in accordance with the AAS. In addition, AASB 101 requires companies to prepare financial statements on a going concern basis and that each material class of the same items need to be presented separately. As per the AASB 101, companies, if they change accounting policies or classification of key items or presentation of items in the financial statements then the same needs to be disclosed properly and that the comparable amount needs to be reclassified unless

impracticable. Here, Pringles Ltd. has changed its depreciation policy and this makes comparison of current financial performance against previous ones irrelevant. This makes disclosure of the change in depreciation accounting practices in the notes compulsory for Pringles Ltd. AASB 101 also requires companies to clearly state in the notes about the reason for changing accounting policies and the nature of the same.

Directors of Pringles Ltd. are required to sign the financial statements of the company. In this context, Zhuang and Luo (2015) mentioned that it is the ethical responsibility of the directors of a company to ensure that the financial statements represent the true and fair view of the financial position of the company. This is important as the stakeholders take vital decisions both financial and non-financial ones, on the basis of the annual report of any company. Thus, unnecessarily changing the depreciation method and then concealing the same from the annual reports is against business ethics as it makes stakeholders like investors and creditors to take decisions based on manipulated information. Business ethics requires companies to communicate correct and

complete information with the stakeholders. Here, changing depreciation for unethically influencing the perceptions of stakeholders is undesirable. Also, concealing the same raises questions over the business ethics of Pringles Ltd. The same can also invite legal actions against the company.

Key findings:

The management of Pringles Ltd. has changed the depreciation method to unethically influence the perception of the shareholders and creditors. In addition, the change in depreciation method is also not disclosed in the financial statements. These are against accepted standards of business ethics. On the other hand, IFRS, AASB 101 and IAS 1 requires companies to mention all material changes in accounting policies, reasons for such changes and other relevant facts in the notes to the financial statements. Pringles Ltd. has not adhered to the same which further raises questions over the effectiveness of corporate governance practices of the company.

Recommendation:

It is advisable for Pringles Ltd. to first disclose the change in depreciation accounting method in the notes to the financial statements. In addition, Pringles Ltd. can convey the change in depreciation accounting policy to its auditors as this could help the company to present a suitable justification to the investors for changing the depreciation policy. In fact, the auditors might help the company in finding an appropriate solution to the current problem. On the other hand, the audit committee is an integral part of the corporate governance system of any company and thus the audit committee of Pringles Ltd. needs to either change back the depreciation method to straight line as earlier or find a suitable solution to the given problem. There also needs to be proper coordination between the audit committee and external auditors of Pringles Ltd. A good justification for changing the depreciation method could be the good profit potential in the concerned years that enables the company to charge maximum depreciation during such years. It is further advisable for Pringles Ltd. to strictly comply with the relevant rules and regulations including AASB 101, IAS 1 and AAS.

Conclusion:

The current report indicates that Pringles Ltd. has indulged in unethical business practices and ineffective corporate governance by intentionally changing depreciation policy and concealing the same to create a false impression among the shareholders. Adherence to relevant accounting standards is a key indicator of good corporate governance however Pringles Ltd. has failed to comply with the same. It is advisable for the company to properly disclose the change in depreciation accounting and coordinate properly with its external auditors.

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