# SUSTAINABILITY, ACCOUNTABILITY AND ETHICS

**Master in Accounting**

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## Agenda

ACCOUNTABILITY AND SUSTAINABILITY

**FINANCIAL REPORTING**

NON-FINANCIAL REPORTING

ETHICS

RESEARCH TOPICS

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## How financial reporting drives accountability? (...and vice versa)

- Agent versus principal
- Auditing (accurate view of the company's financial health)
- Dialogue investors – management (channels of communication)
- Curb possible errors
- Safeguard legitimacy and maintain autonomy
- Improve governance (reduces the chances of corporate mischief)
- Strengthen a company's performance
- Improve the quality of financial reporting

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## What do investors look for in the financial statements?

- Current and forecasted revenue
- Financial performance
- Long-term thinking
- Business cost drivers
- Growth opportunities
- Dividend history
- Profit margins
- Risk
- Cash

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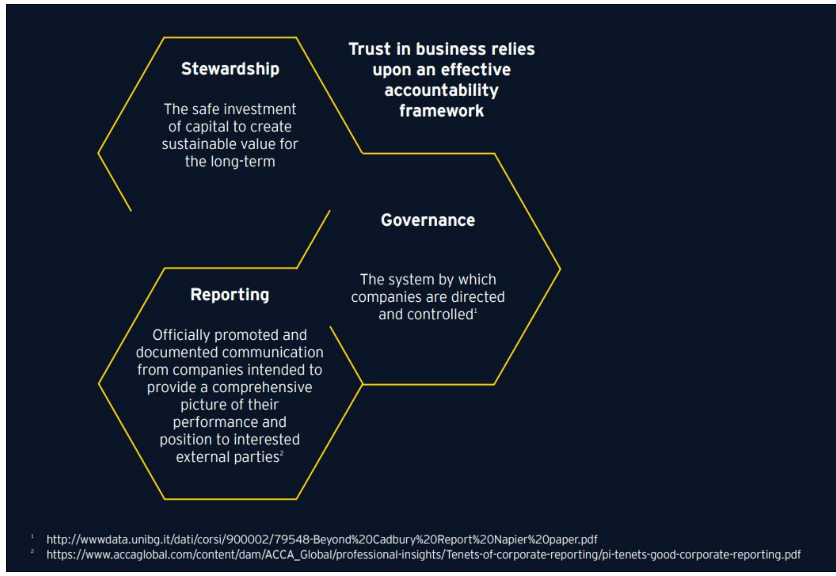
# Accountability and Reporting

- ✓ Deeper dialogue between business, investors and society
- ✓ Role of auditing and assurance

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# Financial statements

Financial statements are critical pieces of information about a company's ability to generate revenue/profit.

How is the company managed?

How stable is the company?

How effective is the use of invested capital?

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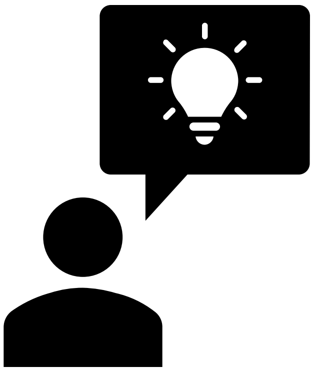
# What can be drawn from the financial statements?



### 1. Is purchasing this stock a good idea?

- If you're considering investing in as an individual or on behalf of your current organization, financial reporting analysis can give you some data that will help you make your decision.
- This is also one way you can gain insight into whether a company is potentially under or overpriced in the stock market.

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# What can be drawn from the financial statements?

### 2. Are we profitable? Will we be in the future?

- This is crucial information.

### 3. How much cash 'runway' do we currently possess?

- Cash is oxygen to a business
- Some companies, like Apple, like to sit on colossal amounts of cash.

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## What can be drawn from the financial statements?

### 4. Do we have the capital to invest in new lines of business?

- Other companies prefer to invest their money, sometimes in a long-term basis. For instance, Intel upgrade their factories and equipment on a regular basis.



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"In a perfect world, investors, board members, and executives would have full confidence in companies' financial statements… Unfortunately, that's not what happens in the real world, for several reasons."

Sherman and Young (2016). Where Financial Reporting Still Falls Short, Harvard Business Review.



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## Investor dashboards


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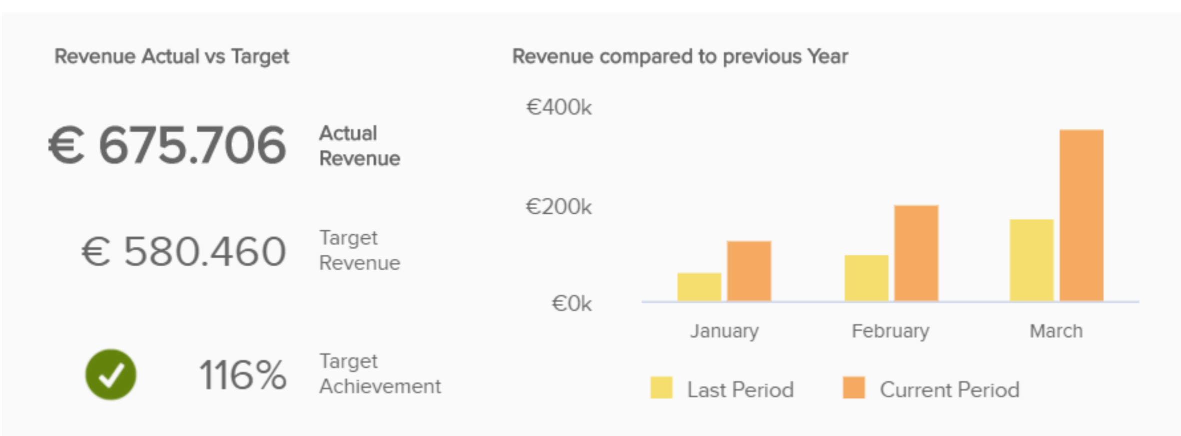
# Revenue and customer overview

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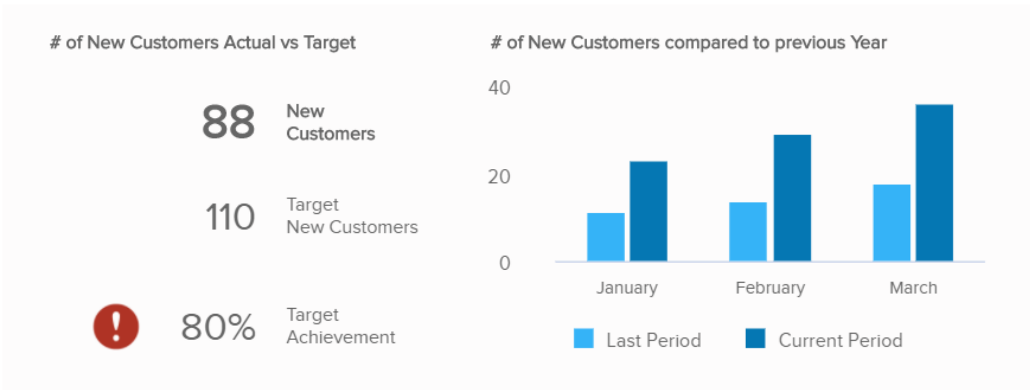
# Revenue and customer overview

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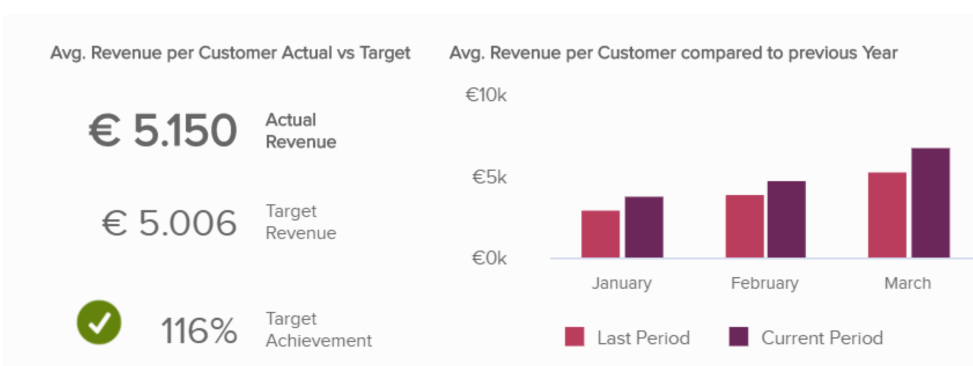
# Revenue and customer overview

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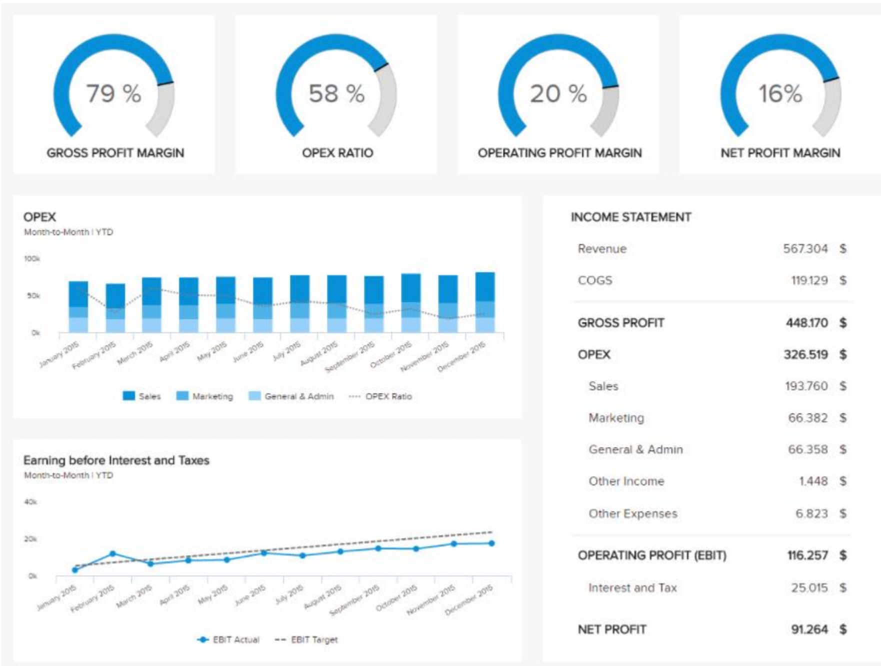

79 %
GROSS PROFIT MARGIN
58 %
OPEX RATIO
20 %
OPERATING PROFIT MARGIN
16%
NET PROFIT MARGIN
OPEX
Month-to-Month I YTD
Sales
Marketing
General & Admin
OPEX Ratio
Earning before Interest and Taxes
Month-to-Month I YTD
EBIT Actual
EBIT Target
INCOME STATEMENT
Revenue 567.304 $
COGS 119.129 $
GROSS PROFIT 448.170 $
OPEX 326.519 $
Sales 193.760 $
Marketing 66.382 $
General & Admin 66.358 $
Other Income 1.448 $
Other Expenses 6.823 $
OPERATING PROFIT (EBIT) 116.257 $
Interest and Tax 25.015 $
NET PROFIT 91.264 $


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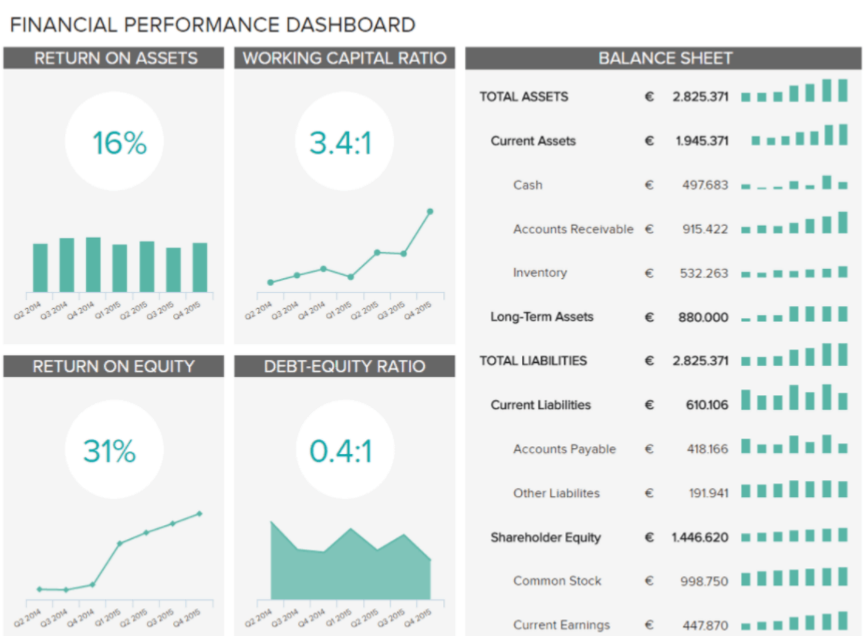

FINANCIAL PERFORMANCE DASHBOARD
RETURN ON ASSETS
16%
WORKING CAPITAL RATIO
3.4:1
RETURN ON EQUITY
31%
DEBT-EQUITY RATIO
0.4:1
BALANCE SHEET
TOTAL ASSETS € 2.825.371
Current Assets € 1.945.371
Cash € 497.683
Accounts Receivable € 915.422
Inventory € 532.263
Long-Term Assets € 880.000
TOTAL LIABILITIES € 2.825.371
Current Liabilities € 610.106
Accounts Payable € 418.166
Other Liabilites € 191.941
Shareholder Equity € 1.446.620
Common Stock € 998.750
Current Earnings € 447.870


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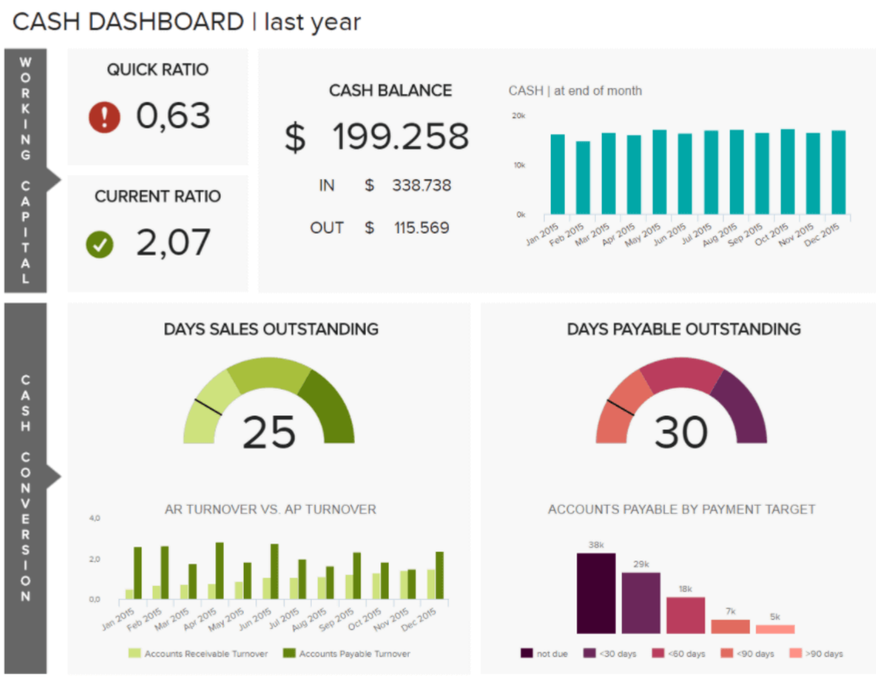


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# Financial statements

- Financial collecting, organizing, and presenting financial information
- There are three primary financial accounting statements prepared according to accounting standards:
  - the balance sheet
  - the income or profit and loss (P&L) statement
  - the statement of cash flows
- Two prevailing systems of accounting standards:
  - Generally Accepted Accounting Principles (GAAP)
  - International Financial Reporting Standards (IFRS)

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## Accounting principles

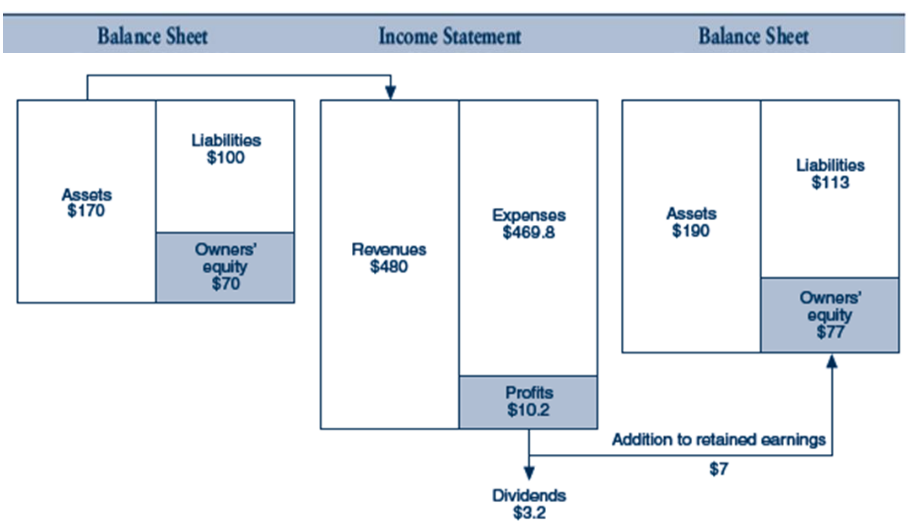
Two basic principles of accrual accounting:

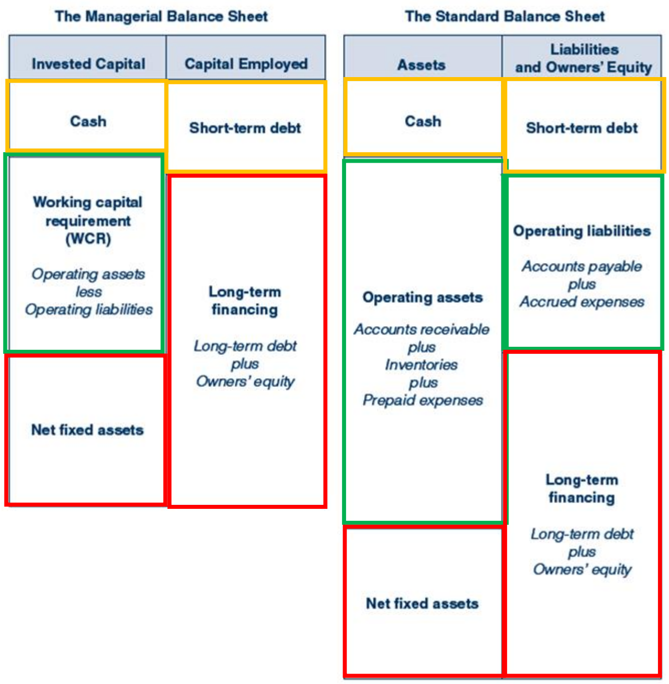
- **Realization principle**: a revenue is recorded when the transaction takes place, not when the cash is received
- **Matching principle**: an expense associated with a revenue is recognized along with the revenue, not when paid





## Reconciling financial statements






The managerial statement of financial position

The 3 financial cycles & Financing strategy

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# THE MANAGERIAL BALANCE SHEET

## INVESTED CAPITAL:

- CASH AND CASH-EQUIVALENT ASSETS
- INVESTMENT IN FIXED ASSETS
- WORKING CAPITAL REQUIREMENT

Working capital requirement (WCR)
=
[Operating assets] – [Operating liabilities]
=
[Accounts receivable + Inventories + Prepaid expenses]
–[Accounts payable + Accrued expenses]

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## THE MANAGERIAL BALANCE SHEET

**CAPITAL EMPLOYED:**

- SHORT-TERM DEBT
- LONG-TERM FINANCING
  - LONG-TERM DEBT
  - OWNERS' EQUITY

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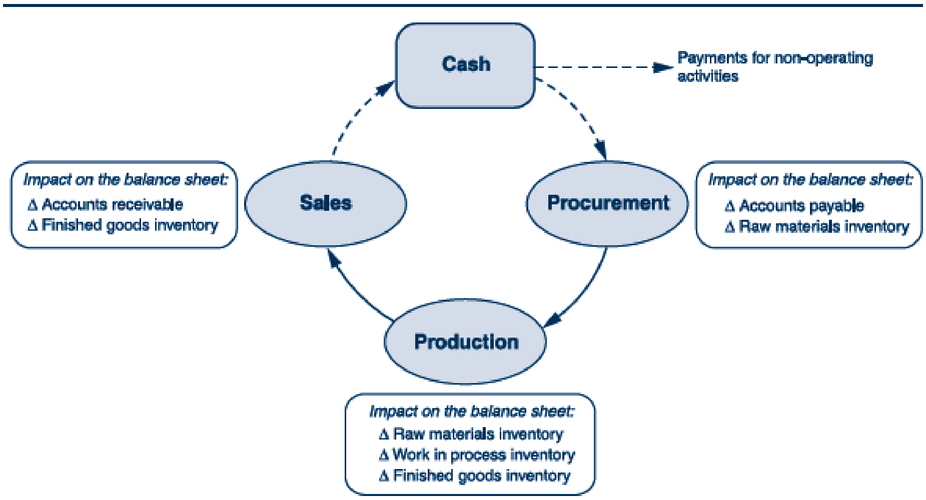
## THE MANAGERIAL BALANCE SHEET

### WORKING CAPITAL REQUIREMENT

THE FIRM'S OPERATING CYCLE AND ITS EFFECT ON THE FIRM'S BALANCE SHEET.

Δ = CHANGE IN THE BALANCE SHEET ACCOUNT

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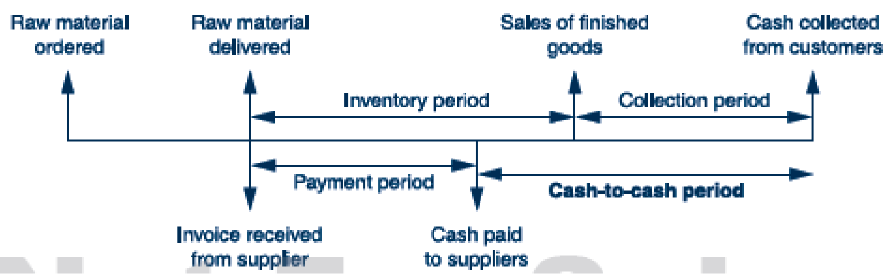
## THE MANAGERIAL BALANCE SHEET
### WORKING CAPITAL REQUIREMENT

THE FIRM'S OPERATING CYCLE, SHOWING THE CASH-TO-CASH PERIOD.



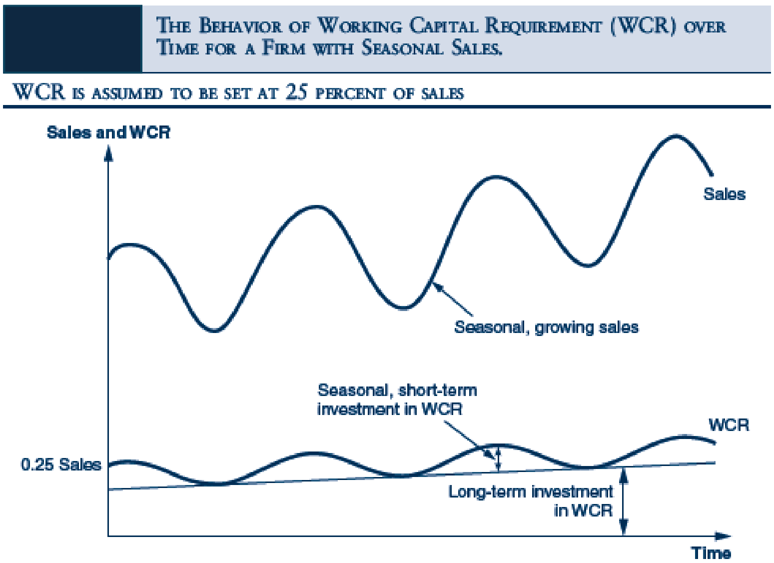





## The matching strategy

- According to the matching strategy, long-term (short-term) investments should be financed by long-term (short-term) funds
- A firm willing to take on some risk by having long-term investments funded short term will be exposed to higher risks
- A risk-averse firm should carry more long-term funds than necessary to finance its long-term investments
- The matching strategy is not necessarily the *optimal* strategy

# The matching strategy

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# The matching strategy

- The WCR of a firm with *seasona*l sales has a *long-term growth* (*permanent* WCR) component and a *short-term seasonal* component. According to the matching strategy, the permanent component should be financed with long-term funds and the seasonal component with short-term funds.

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## The Effect of Sales Growth

- Higher sales will require additional investments in the firm's operating cycle because the firm will need more receivables, more inventories and more payables to support its additional sales
- Working capital requirement and sales have a direct relation
- The working capital requirement increases with inflation





## Traditional measures of liquidity

- **The Current Ratio**

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

- **The Acid Test or Quick Ratio**

$$\text{Acid test or quick ratio} = \frac{\text{Cash} + \text{Accounts receivable}}{\text{Current liabilities}}$$

- Note that these ratios emphasize a *liquidation view* of the firm as opposed to *a going-concern approach*

## Measures of liquidity based on the WCR

- **Net Long-Term Financing**

$$\text{Net long-term financing} = \text{Long-term financing} - \text{Net fixed assets}$$

- **Net Short-Term Financing**

$$\text{Net short-term financing} = \text{Short-term debt} - \text{Cash}$$

- **Liquidity Ratio**

$$\text{Liquidity ratio} = \frac{\text{Long-term financing} - \text{Net fixed assets}}{\text{Working capital requirement}} = \frac{\text{Net long-term financing}}{\text{Working capital requirement}}$$





## Measures of liquidity based on the Cash-flow

- **Cash flow from assets** or **Free cash flow** is the cash flow generated by the firm's assets. It is a measure of the cash flow available to those who finance the firm's activities:

$$\text{Free cash flow} = \text{EBIT}(1 - T_C) + \text{Depreciation expense} - \Delta\text{WCR} - \text{Net capital expenditure}$$

## Improving liquidity through a better management of the operating cycle

- A firm's liquidity will improve when:
  - long-term financing increases, and/or
  - net fixed assets decrease and/or
  - WCR decreases

- The factors affecting WCR:
  - the nature of the **economic sector**
  - the **efficiency** with which the operating cycle is managed
  - the level and growth of **sales**

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## MEASURING MANAGERIAL EFFICIENCY

- **INVENTORY TURNOVER**

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Ending inventories}}$$

The *higher* the inventory turnover, the *lower* the firm's investment in inventories, and the *lower* the working capital requirement

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## Measuring Managerial Efficiency

- **AVERAGE COLLECTION PERIOD**[1]

$$\text{Average collection period} = \frac{\text{Accounts receivable}_{end}}{\text{Average daily sales}}$$

The *shorter* the average collection period, the *lower* the firm's investment in receivables, and the *lower* the working capital requirement

[1] also called **days of sales outstanding** (DOS) or **average age of accounts receivable**





## Measuring Managerial Efficiency

- **AVERAGE PAYMENT PERIOD**

$$\text{Average payment period} = \frac{\text{Accounts payable}_{end}}{\text{Average daily purchases}}$$

The *longer* the average payment period, the *higher* the firm's payables, and the *lower* the working capital requirement

SAE – 2022/2023

# SOLVENCY

- Debt-to-equity = Debt / Equity
- Debt-to-assets = Debt / Assets *(indebtedness ratio)*
- Solvency = (EAT + Depreciation expenses) / Liabilities
- Interest coverage ratio = EBIT / Interest expenses

**Note:** Solvency and liquidity are both terms that refer to an enterprise's state of financial health, but with some notable differences.

Solvency refers to an enterprise's capacity to meet its long-term financial commitments.

Liquidity refers to an enterprise's ability to pay short-term obligations (ability to sell assets to quickly raise cash).

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