

Objectives – Week 7

The primary objective of this week is to develop an understanding of the recording, interpreting and management of liabilities. This includes understanding how to:

1. Record and interpret transactions relating to current liabilities;
2. Calculate and interpret the current and accounts payable ratios as an indicators of short-term liquidity;
3. Identify, report and interpret contingent liabilities;
4. Report and interpret long-term liabilities;
5. Explain and apply the time value of money in accounting for long-term liabilities.

Business Background

- The mix of debt and equity for a company is called the *capital structure*
- The 'ideal capital structure for a firm may change over time and may be different for different firms



**Debt - funds from
creditors**



**Equity - funds
from owners**

Business Background

***Ceteris paribus* extra financing by debt (i.e. borrowing) is considered more risky than extra financing by equity.**

Interest is a legal obligation.



Creditors (debt holders) can force bankruptcy.

Taking on more debt may be a strategic decision by companies...

Business Background

Financial Leverage - The proportion of assets financed by debt

Ratio = Ave TA / Ave SE (Lecture 1)

Possibilities:

(1) If Ratio 1:1 → No debt ($100/100 = 1:1$)

(A of 100 = L of 0 + Eq of 100)

(2) If Ratio 2:1 → Debt equal to Equity ($100 / 50 = 2:1$)

(A of 100 = L of 50 + Eq of 50)

(3) If Ratio > 2:1 → Greater Debt than Equity ($100 / 25 = 4:1$)

(A of 100 = L of 75 + Eq of 25)

Financial leverage ratio (from Lecture 1)



p.81-

- **Goodman Fielder Ltd – year ended 2012**

- Financial leverage ratio =

$$\frac{\text{Average total assets}}{\text{Average shareholders' equity}^*}$$
$$\frac{(\$2,693,800,000 + \$2,783,100,000) / 2}{(\$1,375,100,000 + \$1,300,300,000) / 2}$$
$$\frac{\$2,738,450,000}{\$1,337,700}$$
$$= 2.05 \text{ or 2.05:1}$$

Interpretation:

For every \$1.00 of shareholder investment, Goodman Fielder has \$2.05 invested in assets

Additional interpretation

With a ratio of greater than 1:1, this tells us that Goodman Fielder have a greater reliance on Equity finance than Debt finance (but only just)

Borrowing, ROA and ROE

Impact of gearing on ROE

	Company A No Gearing \$	Company B Gearing \$
Assets	1,000,000	1,000,000
Equity	1,000,000	500,000
Borrowings	-	500,000
Profit (before interest)	300,000	300,000
Interest (15%)	-	75,000
Profit after interest	300,000	225,000
Tax (at 30 cents)	90,000	67,500
Profit after tax	210,000	157,500
Return on equity	21%	31.5%

Management of liabilities is crucial for ensuring longer-term financial stability

Liabilities Defined

- Recall that liabilities are defined as:
 - A present obligation
 - that is probable; and
 - can be reliably measured

- Initially liabilities should be recorded at their current cash equivalent

- Liabilities can be either current or non-current depending on the terms of the agreement

The current ratio is particularly important in debt agreements and other contracts

Key Ratio – Current (Working Capital) Ratio

- Current ratio indicates the relation between the current assets and current liabilities and the ease with which the company can cover its current obligations
- The current ratio is calculated as:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- Higher current ratio generally indicates:
 - Greater ability to meet short term obligations
 - Better financial outlook in the shorter term
- BUT... A Higher current ratio can also have a downside
 - May indicate less-effective management
 - too much invested in slow moving stock and debtors?
- This ratio can be managed (manipulated) through “operational decisions” and “accounting policy choices”

The current ratio – Goodman Fielder 2011

Key Ratio – Current (Working Capital) Ratio

$$\begin{aligned} & \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ = & \frac{\$718,800,000}{\$434,100,000} \\ = & \underline{\mathbf{1.66:1}} \text{ (or 166\%)} \end{aligned}$$

Interpretation:

Benchmark is often 1:1

Goodman Fielder's Ratio is above benchmark – positive

For every \$1 of Current Liabilities (that could be called in in the next 12 months) GF has \$1.66 worth of assets that could be liquidated to meet the commitments. (further test: turnovers...)

Current liabilities have a direct relationship to the operating activities of the business

1. CURRENT LIABILITIES – ACCOUNTS PAYABLE

- A key component of current liabilities for most companies is accounts (or trade) payable

- Companies may choose to manage their accounts payable in various ways
 - a source of short-term finance
 - different degrees of conservatism

The accounts payable turnover can be calculated to understand the company's strategy for managing its payables

Appropriate interpretation of this ratio is crucial as an early indicator of liquidity

Key Ratio – Accounts Payable Turnover

- Indicates the speed at which management is paying its payables

- The accounts payable turnover is calculated as:

$$\frac{\text{Cost of Goods Sold}}{\text{Average Accounts Payable}}$$

- Higher ratio generally indicates:
 - Greater performance in paying accounts payable
- Higher ratio can also have a downside
 - May indicate less-effective management
 - Sufficient use of this as a source of short term finance?
 - Reveals only on average – payment history for individual creditors is not shown

(365 / Accounts Payable Turnover) will convert the ratio from times per period to average accounts payable days

Accounts Payable Turnover – Goodman Fielder 2011

$$\frac{\text{Cost of Goods Sold}}{\text{Average Accounts Payable}}$$
$$\frac{\$1,412,100,000}{(\$313,100,000 + \$275,200,000) / 2}$$

4.8 times par annum
or 365 days / 4.8 = 76.04 days

Interpretation:

Goodman Fielder turns their creditors over 4.8 times a year or on average they take 76.04 days to pay each creditor (taking advantage of a little over 60 day terms)

Companies will commonly disclose a number of other current liabilities

2. CURRENT LIABILITIES – OTHER CURRENT LIABILITIES

- Carbon emissions
- When Greenhouse gas emissions are made by entities, an expense will be incurred and a liability recognised
- This liability will be settled with the government through the surrender of permits/offset

- Taxes payable:
 - e Tax
 - GST
 - Duties

- Employee related costs: - Accrued compensation and related costs, which may include:
 - Salaries and wages
 - Employee entitlements
 - Superannuation
 - Annual leave
 - Long service leave

We will use an example to understand how to account for employee costs and associated liabilities

Accounting For Employee costs (1/6)

- On the first day of October 2009, XYZ Limited employed Mr Ray Ng as its head of New Product Development. Under the employment contract:
 - Mr Ng is to be paid monthly in arrears
 - Mr Ng's final negotiated salary is to be \$36,000
 - Mr Ng's group tax (PAYG) rate = 20%

XYZ LTD		Salary Advice Slip		
Employee Number:	00001			
Employee Name:	Ray Ng			
Pay Period:	1 Oct 2009 – 31 Oct 2009			
Pay Date:	31 October			
Banking Details:	Commonwealth Bank of Australia, 385 Bourke Street Melbourne			
Current Period Earnings		Gross	Deductions	Net
Salary		\$3,000.00	Tax \$600.00	\$2,400.00
Year to Date Details		\$3,000.00	Tax \$600.00	\$2,400.00
Entitlements and Others				
Employer Superannuation Contributions Paid to Wine Employees Super Association 15 July		Details \$3,000.00 * 10%		\$300.00
Annual Leave Entitlement		Days Owing	Days Taken	Other Messages Annual leave days per annum = 20 days (four weeks) 20 / 12 = 1.66 days per month of service
		1.67 days	0 Days	

Gross:
\$36,000 /
12

Tax:
\$3,000 x
20%

Net:
\$3,000 -
\$600

The first component we need to account for relates to the salaries and wages component of employee costs

Accounting For Employee costs (2/6)

- The journal entry would be:

KEY CONCEPT (Core Employee Costs)

Date	Description	Dr	Cr
29-Dec-10	Salary Expense (+Ex)	3,000	
	PAYG Tax Withheld (+L)		600
	Bank (-A)		2,400
	<i>(Recording the payment associated with first months salaries)</i>		

Owed to the ATO and reported on Balance Sheet. Reduces as payments are made quarterly for small business

In addition, there are a number of costs that are incurred on top of the base pay

Accounting For Employee costs (3/6)

- In addition to salaries and wages, Australian employers must also pay **employee entitlements** which are typically incurred at a specified percentage of an employee's gross salary or wage:
 - Superannuation 7.5 – 15 % (*10% for Mr Ng*)
 - Workcover 2 – 3.5 % (*3% for Mr Ng*)
 - Payroll tax 1 – 2.5 % (*2% for Mr Ng*)

KEY CONCEPT (Employee Entitlements)

(Recording the entitlements associated with first months salaries)

*Operating Cash
Outflows or
Current Liabilities*

The final employee cost we will consider in detail is annual leave

Accounting For Employee costs (4/6)

- In Australia employees typically receive four weeks (20 days) paid annual leave for each year (52 weeks) of employment
- The annual entitlement is then calculated as 4/52 of the employee's salary and related on-costs

- The annual leave liability relating to Ray Ng is calculated as follows:

• Annual Salary	36,000
• Superannuation (36,000 x 10%)	3,600
• Workcover (36,000 x 3%)	1,080
• Payroll tax (36,000 x 2%)	<u>720</u>
• Total employee-related costs	<u>\$41,400</u>

- Annual leave cost per year =
 $41,400 \times 4/52 = \$3,185$

- Annual leave cost per month = $3,185 \times 1/12 = \$265$

The annual leave provision is recorded with each salary payment and then consumed as employees take leave

Accounting For Employee costs (5/6)

- Annual leave is a liability whose timing is uncertain => a provision recorded as follows:

KEY CONCEPT (Annual Leave Liability)				
Date	Description	Dr	Cr	
29-Dec-10	Annual Leave Expense (+Ex)	265		
	Provision for Annual Leave(+L)		265	
	<i>(Annual leave cost per year =</i>	<i>41,400 x 4/52 = \$3,185</i>		
	<i>Annual leave cost per month =</i>	<i>3,185 x 1/12 = \$265)</i>		

As an employee takes any portion of their annual leave entitlement the provision is decreased

There are several additional employee costs that must also be recorded...detailed in future accounting studies

Accounting For Employee costs (6/6)

- Other employee costs that could be considered:
 - Sick leave
 - Long service leave
 - Share- based remuneration
 - Aligning managers' interests with shareholders

- Note the importance of internal controls over the payroll function
 - Controls to ensure:
 - Accuracy of payments
 - Proper authorisation
 - Security of information

In addition to other liabilities, some obligations are only able to be estimated



3. CONTINGENT LIABILITIES

- Possible future sacrifices which rely on a future event
- Why disclose?
- Disclosure depends on probability of occurrence
 - Probable
 - Reasonably possible
 - Remote
- Common examples
 - Law suits
 - Third party guarantee
 - Other

Contingent Liabilities

	Probable	Possible	Remote
Amount . . .	Record the liability.	Disclose the liability in the notes to the financial stmts.	No action.
Can be Estimated	Record the liability.	Disclose the liability in the notes to the financial stmts.	No action.
Cannot be Estimated	Disclose the liability in the notes to the financial stmts.	Disclose the liability in the notes to the financial stmts.	No action.

To fund operational and strategic objectives, companies may use various forms of finance

4. LONG-TERM LIABILITIES

- (A) Equity - shares (various types) (next week)

- (B) Debt – (Deferred) Liabilities
 - Mortgages
 - Debentures
 - Notes and bills
 - Leases
 - Operating versus finance leases
 - Present value and fair value

- Each form of finance imposes different rights and obligations on the borrower and the lender

We look in more detail at issues relating to the accounting for some of these liabilities (debentures and leases) now

Debentures are a type of finance commonly used by companies seeking to raise large amounts of capital

Debentures

- Characteristics
 - Smaller denominations
 - Par value, specified interest rate and term
 - Other

- Rationale for issuing

- Other issues
 - Determining the issue price
 - Effect on ratios
 - Security given up

In accounting for many long term liabilities, the time value of money is important

Time Value of Money

The next few slides explain some concepts and procedures that are relevant for recording:

- Some Deferred Liabilities that may be subject to a repayment plan over time, and
- Assets that are financed through a leasing transaction

Using simple formulae you can determine the time adjusted value of a cash flow...present or future

Present Value (PV) and Future Value (FV)

- Apply the following definitions:
 - i = interest rate
 - n = number of compounding periods

KEY CONCEPT (Time Value Calculations)

Future Value
(FV)

= Present Value $\times (1 + i)^n$
= Present Value \times Discount Factor (*text website*) ([see end](#))

Present Value
(PV)

= Future Value $/ (1 + i)^n$
= Future Value \times Discount Factor (*pg 983*)

- Example:
 - What is the future value of \$100 in 3 years time at 14%p.a compounding interest?
 - $FV = \$100 \times (1+.14)^3 = \148.15 , or using the table on text website,
 - $FV = \$100 \times 1.482 = \148.20 ([see also FV tables](#))

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