

**Accounting  
Building Business Skills**

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Chapter Nine:  
Reporting and Analysing Liabilities  
and Shareholders' Equity

PowerPoint presentation by Kate Wynn-Williams  
University of Otago, Dunedin  
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**Learning Objectives:**

- Identify and discuss the main characteristics of a corporation.
- Record the issue of ordinary shares.
- Prepare the entries for cash dividends and share dividends.
- Explain the difference between current and non-current liabilities.

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**Learning Objectives:**

- Identify major types of current liabilities and explain how to account for them.
- Prepare the accounting entries for unsecured notes and debentures payable.
- Evaluate a company's liquidity and solvency in terms of the assets available to pay liabilities.

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**Characteristics of a Corporation**

- separate legal existence
- limited liability of shareholders
- transferable ownership rights
- continuous life
- ability to acquire capital
- company managed through elected board of directors
- subject to government regulations <sub>4</sub>

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**Characteristics of a Corporation**

- registered companies bound by Corporations Act
- shareholders = owners of company
- rights of ownership given through shares issued
- different rights for different classes of shares

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**Characteristics of a Corporation**

- Preference shares – priority over ordinary shares with respect to dividends and/or repayment of capital
- Ordinary shares – most common type

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## Characteristics of a Corporation (cont.)

### Shareholders have the right:

1. To vote in election of board of directors at annual general meeting. To vote on actions that require shareholder approval.



2. To share the company profits through receipt of dividends.



3. To share in assets on liquidation in proportion to their holdings. This is called a residual claim because owners are paid with assets that remain after all claims have been paid.



Lenders



Shareholders



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## Equity: share issues

- Company exchanges equity (shares) for assets (usually cash)
- Private placement – to specific potential investors
- Public issue – prospectus sent to the general public inviting applications to purchase shares

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## Equity: share issues

journal entry for private placement:

Dr Cash                    \$1,000  
    Cr Share Capital            \$1,000  
(to record issue of 1000 shares at \$1)

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### Equity: share issues

journal entries for public issue:

- prospective investors return application form with application money:

Dr Cash Trust \$5,000

Cr Application \$5,000

(to record receipt of application money – for 10,000 shares issued with \$0.50 due on application and \$0.20 upon allotment)

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### Equity: share issues

- company issues shares in response to applications received:

Dr Application \$5,000

Cr Share Capital \$5,000

(to record application money towards price of issued shares)

Dr Allotment \$2,000

Cr Share Capital \$2,000

(to record amounts still owing towards price of issued shares)

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### Equity: share issues

- company can now transfer money received out of trust account:

Dr Cash at Bank \$5,000

Cr Cash Trust \$5,000

(to record transfer of money from trust account into bank account)

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### Equity: share issues

- when further money is received in response to allotment of shares:

Dr Cash at Bank \$2,000  
Cr Allotment \$2,000  
(to record receipt of the \$2000 due upon allotment of shares)

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### Equity: share issues

- journal entries thus far assume full payment of money owing when due, and full payment for shares upon allotment
- sometimes companies do not ask for full payment upon allotment
  - the company may keep some funds as unpaid share capital
  - shareholder pays this when company calls for it

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### Reporting Equity

- Statement of Financial Position has three principle components within equity section
  - share capital: contributed equity (paid and any outstanding amounts)
  - retained profits: prior profits kept within company and not distributed as dividends
  - reserves: changes in equity not created through transactions with owners

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### Equity: Dividends

- distribution of profits to shareholders
- paid on a pro rata basis
- usually cash payments
- can also be further issue of shares or transfer of property

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### Equity: Cash Dividends

- for payment of cash dividends, the company must have:
  - adequate retained profits
  - adequate cash available without compromising solvency
  - dividends need to be declared by directors

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### Equity: Cash Dividends

- when dividend is declared:  
Dr Retained Profits \$50,000  
Cr Dividend Payable \$50,000  
(to record cash dividend declared)
- when dividend is paid:  
Dr Dividend Payable \$50,000  
Cr Cash \$50,000  
(to record cash payment)

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### Equity: Share Dividends

- increases shareholder investment in the company
- increases total number of issued shares
- not a cash payment
- signals this amount of retained profits is not available to shareholders as cash dividend

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### Equity: Share Dividends

- when dividend is declared:  
Dr Retained Profits     \$50,000  
  Cr Share Dividend Payable   \$50,000  
(to record cash dividend declared)
- when dividend is paid:  
Dr Share Dividend Payable   \$50,000  
  Cr Share Capital             \$50,000  
(to record issue of 5000 shares at \$10)

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### Liabilities: current vs non-current

- liabilities:
  - current obligation
  - resulting from past transaction
  - involving future sacrifice of economic benefits
- current – expect to be settled within 1 year or current operating cycle, whichever is longest
- non-current – more than 1 year or current operating cycle

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**Liabilities: current**

- level of current liabilities affects solvency
- most common current liabilities:
  - accounts payable
  - notes payable
  - revenue received in advance
  - other accrued liabilities (e.g. taxes, salaries and wages, interest)

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**Liabilities: current**

Accounts Payable:

- short-term credit arrangement
- for credit purchase of goods or services from suppliers
- also called Creditors or Trade Creditors
- usually one of largest current liabilities of company
- usually settled within a month

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**Liabilities: current**

Notes Payable:

- written documentation (if needed for legal remedies)
- varying periods of time for repayment
- usually involve interest payments

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**Liabilities: current**

Notes Payable:

- journal entry when note issued:

Dr Cash \$100,000  
Cr Notes Payable \$100,000  
(to record issue of 12%, 4-month note)

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**Liabilities: current**

Notes Payable:

- journal entry to record interest:

Dr Interest Expense \$4,000  
Cr Interest Payable \$4,000  
(to record accrued interest for 4 months)

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**Liabilities: current**

Notes Payable (cont):

- journal entry to settle liabilities:

Dr Notes Payable \$100,000  
Dr Interest Payable \$4,000  
Cr Cash \$104,000  
(to record cash payment of note and interest)

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## Liabilities: current

### Payroll-related current liabilities:

- salary and wages recorded as earned
- also pay-as-you-go tax (PAYG)
- may also include other employee deductions (e.g. medical funds, union fees)

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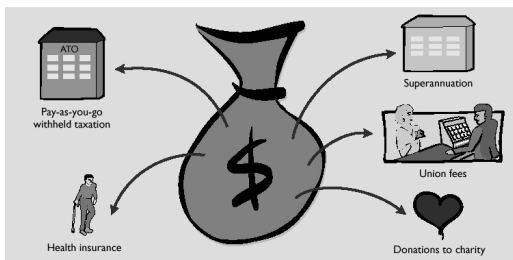
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## Liabilities: current (cont.)



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## Liabilities: current

### Payroll liabilities:

- journal entry when liability accrued:  
Dr Salary & Wages Expense \$100,000  
Cr PAYG Tax Payable \$32,036  
Cr Salary & Wages Payable \$67,964  
(to record employee wages and tax payable)

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**Liabilities: current**

Payroll liabilities:

- journal entry when liabilities paid:  
Dr PAYG Tax Payable \$32,036  
Dr Salary & Wages Payable \$67,964  
Cr Cash \$100,000  
(to record payment of employee wages and tax payable)

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**Liabilities: current**

Revenue received in advance:

- when customers pay ahead of time for goods or services to be received in the future
  - magazine subscriptions, season passes to sports events

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**Liabilities: current**

Revenue received in advance:

- journal entry when money received:  
Dr Cash \$50,000  
Cr Revenue rec'd in advance \$50,000  
(to record advance purchase of passes)

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**Liabilities: current**

Revenue received in advance (cont.):

- journal entry as service delivered:  
Dr Revenue rec'd in advance \$10,000  
Cr Revenue \$10,000  
(to record delivery of service to customer)

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**Liabilities: current**

Current maturity of long-term debt:

- as portions of long-term debt become due within next year, adjustments are made to the statement of financial position
  - no journal entry is needed

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**Liabilities: non-current**

- level of non-current liabilities affects long-term stability
- used for long-term financing
- most common non-current liabilities:
  - bank loans
  - long-term notes (unsecured or debentures)

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## Liabilities: non-current

- debentures – secured over assets
- unsecured notes – not secured over assets
- long-term debt has advantages:

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## Liabilities: non-current (cont.)

Debt financing	Advantages
	1. <b>Shareholder control is not affected.</b> Noteholders do not have voting rights, so current owners (shareholders) retain full control of the company.
	2. <b>Tax savings result.</b> Interest is deductible for tax purposes; dividends on shares are not.
	3. <b>Earnings per share may be higher.</b> Although interest expense reduces net profit, earnings per share often is higher under debt financing because no additional shares are issued.

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## Liabilities: non-current

characteristics of long-term debt:

- face value – amount of principal due at maturity date
- contractual interest rate – determines amounts of cash interest paid by borrower to investor
- market value – what investor is willing to pay for the debt

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### Liabilities: non-current

- present value – face value plus contractual interest rate for the life of the debt, stated in today's equivalent dollar terms
  - affected by cash amounts to be received (face value + contractual interest rate),
  - by length of time until investor receives cash, and
  - by current market rates

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### Liabilities: non-current

- accounting records kept when long-term debt issued and repaid
- if investor sells to another investor, no accounting record for company
- face value of long-term debt is often different than amount of cash received from investors
  - premium – if market rates < contract
  - discount – if market rates > contract

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### Liabilities: non-current

- journal entries for debentures and unsecured notes the same
  - differences arise in security offered to investors by company
  - "Notes Payable" used instead of "Debentures"
- when issued at face value:  
Dr Cash           \$100,000  
  Cr Debentures Payable \$100,000  
(to record cash received for issue of long-term debt)

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### Liabilities: non-current

- redemption of long-term debt is always at face value, regardless of issue price
- when redeemed at maturity:  
Dr Debentures Payable \$100,000  
Cr Cash \$100,000  
(to record cash paid to redeem debt)

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### Liabilities: non-current

- when redeemed early, Loss or Gain recognises difference between face value and cash paid to investors:  
Dr Debenture Payable \$100,000  
Dr Loss on Redemption \$3,000  
Cr Cash \$103,000  
(to record cash paid to redeem debt)

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### Financial Statement Analysis

- Liquidity Ratios – reflect the short-term ability to meet debt obligations
- working capital
  - current ratio
  - quick ratio – like the current ratio, but modified to remove some non-liquid current assets

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## Financial Statement Analysis

### Liquidity Ratios

$$\text{Working capital} = \text{Current assets} - \text{Current liabilities}$$

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

$$\text{Quick ratio} = \frac{\text{Cash} + \text{Marketable securities} + \text{Net receivables}}{\text{Current liabilities}}$$

Telstra Corporation		
(\$ in millions)	2001	2000
Working capital	\$6253 - \$9279 = -\$3026	\$4889 - \$9421 = -\$4532
Current ratio	$\frac{\$6253}{\$9279} = 0.67:1$	$\frac{\$4889}{\$9421} = 0.52:1$
Quick ratio	$\frac{\$1077 + \$4307}{\$9279} = 0.58:1$	$\frac{\$751 + \$3587}{\$9421} = 0.46:1$

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## Financial Statement Analysis

Solvency Ratios – reflect the long-term ability to survive

- debt to total assets
- times interest earned – indicates the company's ability to service their debt (meet interest payments)

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## Financial Statement Analysis

### Solvency Ratios

$$\text{Debt to total assets ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

$$\text{Times interest earned} = \frac{\text{Profit before income tax} + \text{Interest expense}}{\text{Interest expense}}$$

Telstra Corporation		
(\$ in millions)	2001	2000
Debt to total assets ratio	$\frac{\$23,751}{\$37,473} = 0.63:1$	$\frac{\$18,737}{\$30,339} = 0.62:1$
Times interest earned	$\frac{\$6297 + \$769}{\$769} = 9.2 \text{ times}$	$\frac{\$5349 + \$630}{\$630} = 9.5 \text{ times}$

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